

# The Implications of the Sarbanes-Oxley Act for U.S. Foreign Relations

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## INTRODUCTION

On July 30, 2002, The Sarbanes-Oxley Act, commonly known throughout the world as SOX, and was passed into law with President Bush's signature after an overwhelming majority of Congress voted in favor of the Act. Sarbanes-Oxley shocked both the U.S. and international accounting communities upon its passage. The primary goal of this law is to protect U.S. investors from future accounting scandals. In the wake of the accounting scandals that rocked U.S. capital markets in the early part of the century, it is "no surprise the issue of corporate governance in the beginning of 2002 became top of the U.S. political agenda."<sup>1</sup>

What is surprising, however, is the significant impact this sweeping piece of legislation has had on countries throughout the world. With over 1300 foreign companies currently listed on U.S. markets, SOX is inherently an all-encompassing international affair that has affected the world tremendously since its creation.<sup>2</sup> In addition to domestic entities, Sarbanes-Oxley impacts foreign companies who are listed on U.S. exchanges and those foreign accounting firms who provide services to any U.S.-listed company.<sup>3</sup> The scope of the Act on entities abroad inevitably raises the question of extraterritoriality. The extraterritorial application of SOX has hindered the United States' foreign relations with numerous countries throughout the world, resulting in the emergence of political, legal, and economic repercussions.

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<sup>1</sup> Becker, Tim and Clarke, Peter. "Is Washington Now the Omnipotent Regulator of the European Financial System?" Ethical Corporation: Not an Oxymoron. <http://www.ethicalcorp.com/content.asp?ContentID=233> (accessed April/20, 2008).

<sup>2</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." 2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review (Spring, 2004).

<sup>3</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

Sarbanes-Oxley's convoluted language and complicated requirements have left domestic and foreign parties to struggle with the implementation of this legislation. Auditors, lawyers, politicians and executives have all partaken in the laborious plight to incorporate SOX into their professional practices.<sup>4</sup> Tim Becker and Peter Clarke summarize the challenge foreign companies face with SOX by stating, "Simply put, a British or French company with a secondary listing on the New York Stock Exchange must comply with all provisions of the Sarbanes Oxley Act, unless there is an available exemption [...]."<sup>5</sup> With a minimal number of SOX exemptions granted thus far, the idea that this law will require entities throughout the world that participate in U.S. markets to comply with the rules and regulations set forth by SOX regardless of nationality has not produced a favorable reaction. Consequently, this negative perception of SOX has resulted in increased efforts internationally to restructure the public accounting profession as an alternative to enduring the U.S. reforms.<sup>6</sup>

Protecting investors worldwide and improving public company audits is a righteous objective and SOX will undoubtedly assist regulators in achieving this objective. However, as many critics of the law argue, that is not to say that Sarbanes-Oxley is the optimal solution, especially for international entities.<sup>7</sup> With varying legal, institutional, and cultural systems throughout the world, it is imperative to resort to diplomacy and dialogue when a far-reaching piece of legislation such as SOX is created.

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<sup>4</sup> Better Governance and Reporting Under Sarbanes - Oxley : Are we there Yet? Mondaq Business Briefing, November 23, 2004.

<sup>5</sup> Becker, Tim and Clarke, Peter. "Is Washington Now the Omnipotent Regulator of the European Financial System?" Ethical Corporation: Not an Oxymoron. <http://www.ethicalcorp.com/content.asp?ContentID=233> (accessed April/20, 2008).

<sup>6</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>7</sup> Ibid.

Becker and Clarke state, “In today’s global economy, the need for international consultation is essential, even if the argument that the U.S. has every right to regulate its own securities markets is a compelling one.”<sup>8</sup>

The United States’ decision to pass Sarbanes-Oxley into law without a more careful and thorough consideration of its international implications has created a strong negative reaction that, over five years later, has still not been resolved. This is a major problem that the U.S. must address or else it will continue to receive backlash from the international community. By requiring foreign entity compliance with SOX regulations, the U.S. is threatening the sovereignty of foreign nations and tarnishing its image abroad. If the U.S. does not develop an alternative arrangement for foreigners with respect to Sarbanes-Oxley, the U.S. will further isolate itself, suffering politically, economically, and socially.

The intent of this study is to describe in detail the impact of Sarbanes-Oxley from economic, legal and political perspectives and the subsequent implications for U.S. foreign relations. The purpose of this study is not to provide the ultimate solution to safeguard U.S. investors from corporate misconduct. Rather, this paper identifies the context of the problems that emerged as a result of the impulsive legislation and evaluates alternative solutions to the original Act. PART I of the study examines the PCAOB registration process and interprets Sections 102 and 106 of the Act, which address domestic and foreign registration, respectively. This section also describes the impact of Sarbanes-Oxley on the public accounting profession and the challenges that arise from SOX compliance and PCAOB inspection. PART II of the study focuses on the history of

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<sup>8</sup> Becker, Tim and Clarke, Peter. "Is Washington Now the Omnipotent Regulator of the European Financial System?" Ethical Corporation: Not an Oxymoron. <http://www.ethicalcorp.com/content.asp?ContentID=233> (accessed April/20, 2008).

U.S. securities legislation and its traditional stance with respect to foreign entities. This section then explores the international challenges of SOX and contrasts it with previously established U.S. securities laws. PART III surveys the economic, legal, and political impact of the Act and the subsequent implications for U.S. foreign relations. PART IV of the study examines the demand for alternative solutions to Sarbanes-Oxley and evaluates two different alternatives that have been discussed as viable options to the Act in recent years. Finally, the study concludes with an assessment of the development of SOX and the PCAOB since 2002.

## PART I

### *PCAOB Registration:*

Title I of the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board, commonly referred to as the PCAOB.<sup>9</sup> The principal role of the PCAOB is to protect U.S. investors, primarily through oversight of public accountants charged with the role of auditing U.S. public companies. The Board oversees the conduct of all registered firms. Under SOX, all public accounting firms who participate in the financial statement audits of publicly listed companies in the United States must register with the PCAOB. One source notes, “Registration is a key to the PCAOB’s powers in that registration with the PCAOB opens registering firms to inspections and sanctions by the PCAOB.”<sup>10</sup> Registration essentially provides the PCAOB complete authority under SOX over those firms registered, U.S. and foreign firms alike. Its authority, in addition

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<sup>9</sup> One Hundred Seventh Congress of the United States of America. *Sarbanes-Oxley Act of 2002*. Translated by U.S. Congress. Vol. H.R. 3763--21Federal, 2002, [news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf](http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf) (accessed November 30, 2007).

<sup>10</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

to developing standardized audit practices that firms must follow, includes the ability to assign penalties to any registered firm found to be in violation of Sarbanes-Oxley or any section of it.<sup>11</sup>

It has been said that the idea behind requiring firms to register with the Board is to attain greater control over the public accounting profession and to better monitor its activities, thus avoiding future auditing deficiencies.<sup>12</sup> Currently there are 1848 public accounting firms registered with the PCAOB.<sup>13</sup> This sizeable number of registrants clearly demonstrates the power of the Board over the global public accounting profession. In order to determine whether the Board's objectives as established by SOX have been achieved, it is necessary to analyze the sections of the Act that establish the framework for PCAOB registration. Section 102 of the Act focuses on domestic registration requirements while section 106 specifically addresses the registration of foreign accounting entities.

### *Section 102*

The first paragraph under section 102 discusses the mandatory registration required of U.S. public accounting firms. The legislation states, "It shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer."<sup>14</sup> Therefore, any accounting firm that actively participated in preparing a U.S. listed

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<sup>11</sup> Ibid.

<sup>12</sup> PCAOB-Beyond the First Year. *Mondaq Business Briefing*, July 15, 2004.

<sup>13</sup> Public Company Accounting Oversight Board. PCAOB 2008-2013 Strategic Plan 2008, [www.pcaobus.org](http://www.pcaobus.org) (accessed May 2, 2008).

<sup>14</sup> One Hundred Seventh Congress of the United States of America. *Sarbanes-Oxley Act of 2002*. Translated by U.S. Congress. Vol. H.R. 3763--21Federal, 2002, [news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf](http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf) (accessed November 30, 2007).

company's audit report can no longer continue to do so by law without registering with the PCAOB.

The subsequent paragraph explains the process of registering with the Board and provides a detailed description of the information necessary to completing the application for registration. The content of the application must include a list of the prior year public companies audited by the firm, a list of the companies the firm believes it will audit in the current year, a fees disclosure, and any other financial information deemed necessary and thereby requested by the Board.<sup>15</sup> Additionally, the firm must disclose its financial statement audit control processes, provide a record of its employed accountants including their licensing information, divulge information about pending disciplinary proceedings concerning possible audit report deficiencies, if any, and also provide copies of disclosures pertaining to accounting disagreements between the firm and its clients.<sup>16</sup> Finally, the legislation creates a “catch-all” clause for registration, requiring firms to release “such other information as the rules of the Board or the [Securities and Exchange] Commission shall specify as necessary or appropriate in the public interest or for the protection of investors.”<sup>17</sup> This final clause ultimately gives the Board total discretion over the information it can instruct firms to provide in order to register with the PCAOB. Finally, it is required that firms comprehend and consent to the rules of registration established by the Board as well as the implications of SOX regarding continued compliance in the future.<sup>18</sup>

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<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.



The final three paragraphs of section 102 are vital to fully understand the impact Sarbanes-Oxley has on registered firms and their business practices. Paragraph (d) of the section describes the mandatory annual report registered firms must issue each year and update as necessary per the Board's request.<sup>19</sup> This will increase the workload of public accounting firms by a significant amount each year as well as the costs of SOX compliance. Paragraph (e) reveals that information provided to the Board by registered firms will be made available to the public unless the Board deems part of it to be sensitive in nature to the firm.<sup>20</sup> If, on a case-by-case basis, the Board deems particular information to be sensitive to a firm, this select information will be shielded from public release. This introduces the issue of intellectual property and confidentiality laws, raising speculation from critics that SOX possibly is in violations of these statutes. The final part of this section, paragraph (f), introduces the fees provision, which requires that firms pay both an initial registration fee and subsequent fees each year thereafter to the Board.<sup>21</sup> This will undoubtedly provide an additional financial burden to accounting firms and it is interesting to note that the Board has the discretion to determine the appropriate fee amount firms will need to pay. Per the Board's 2008 Budget approved by the SEC and released late in 2007, the 2008 accounting support fee is an estimated \$134.5 million (See attached budget).<sup>22</sup> This amount is funded both by public companies listed in the U.S. and PCAOB registered accounting firms in a manner outlined in detail in Section 109 of the Act.

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<sup>19</sup> Ibid.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

<sup>22</sup> Public Company Accounting Oversight Board. 2008 Budget by Area, December 2007 [www.pcaobus.org](http://www.pcaobus.org) (accessed May 2, 2008).

### *Section 106*

Section 106 is vital to the understanding of Title I of Sarbanes-Oxley because it describes the influence this piece of U.S. legislation will have on foreign accounting firms and the international community in general. As one source notes, “With the global economy and the international structure of audit clients, it is inevitable that accounting firms will need to rely on foreign accounting firms and other entities in order to complete certain [parts] of their audit reports.”<sup>23</sup> Consequently, it is no surprise that SOX specifically addresses the treatment of foreign accounting firms and the role that they play in completing the audits of U.S. public companies. What is surprising, however, is the lack of distinction between what is required of domestic firms under the Act and what is now required of foreign firms.

The first paragraph of section 106 defines the applicability of Sarbanes-Oxley to foreign public accounting firms. The legislation reads:

Any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer, shall be subject to this Act and the rules of the Board and the Commission issued under this Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States, or any state, except that registration pursuant to section 102 shall not by itself provide a basis for subjecting such a foreign public accounting firm to the jurisdiction of the Federal or State courts, other than with respect to controversies between such firms and the Board.<sup>24</sup>

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<sup>23</sup> PCAOB-Beyond the First Year. *Mondaq Business Briefing*, July 15, 2004.

<sup>24</sup> One Hundred Seventh Congress of the United States of America. *Sarbanes-Oxley Act of 2002*. Translated by U.S. Congress. Vol. H.R. 3763--21Federal, 2002, [news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf](http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf) (accessed November 30, 2007).

In other words, those foreign entities involved in the audits of companies listed on U.S. securities exchanges have to register with the PCAOB and will, in theory, avoid reporting to the U.S. courts system provided that they are in full compliance with the tenets of Sarbanes-Oxley. This paragraph also clarifies the authority of the Board over these foreign firms. The legislation essentially mandates that it is necessary for the foreign firms to register with the PCAOB in the interest of investor protection even if they do not directly issue the audit report for a public company but play a significant role in the audit process.<sup>25</sup> This “associated entity” clause not only affects foreign firms who now must register even though they are not issuing the audit report, but it also significantly influences domestic accounting firms.<sup>26</sup> Accordingly, domestic firms that base some of their opinion on supplemental work conducted by foreign firms during the course of the audit are prohibited from relying on it unless the firms are officially registered with the PCAOB.<sup>27</sup>

The following paragraph discusses the role of both foreign and domestic firms in the production of foreign audit workpapers to the Board. This section of the Act stipulates that, by registering, foreign firms are assumed to have consented to the production of their workpapers to the Board if requested to do so.<sup>28</sup> Additionally, foreign firm registration assumes having consented “to be subject to the jurisdiction of the courts of the United States for purposes of enforcement of any request for production of such

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<sup>25</sup> Ibid.

<sup>26</sup> PCAOB-Beyond the First Year. *Mondaq Business Briefing*, July 15, 2004.

<sup>27</sup> Ibid.

<sup>28</sup> One Hundred Seventh Congress of the United States of America. *Sarbanes-Oxley Act of 2002*. Translated by U.S. Congress. Vol. H.R. 3763--21Federal, 2002, [news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf](http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf) (accessed November 30, 2007).

workpapers.”<sup>29</sup> On the other hand, those domestic firms registered with the Board have also provided implied consent to the PCAOB. In this case, domestic firms working with foreign counterparts during the course of an audit have assumed the responsibility to help the Board obtain necessary foreign workpapers. Domestic firms are also responsible for securing a commitment from their foreign counterparts to cooperate with the PCAOB when necessary.<sup>30</sup>

The final two paragraphs of section 106 provide clarity pertaining to the Board’s intended treatment of foreign accounting firms and the firms to which it foresees SOX as being applicable to. Paragraph (c) describes the power that the PCAOB has to grant exemptions to foreign firms.<sup>31</sup> Basically, this clause grants the PCAOB the power to exempt foreign firms from complying with certain parts of the Act provided that investors’ interests remain protected. Additionally, paragraph (d) attempts to clarify the meaning of foreign accounting firm to distinguish from that of a domestic accounting firm. SOX reads, “In this section, the term ‘foreign public accounting firm’ means a public accounting firm that is organized and operates under the laws of a foreign government or political subdivision thereof.”<sup>32</sup> It is interesting to note that the concluding paragraph of a section devoted to emphasizing the similar treatment of foreign and domestic firms under SOX stresses a distinction between foreign and domestic firms that essentially lacks little meaning to the application of this law in practice.

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<sup>29</sup> Ibid.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid.

<sup>32</sup> Ibid.

### *Application of Sections 102 & 106*

Upon the acceptance of Sarbanes-Oxley into United States law, both the domestic and international communities began to recognize the far-reaching effect this law has. The former European Commissioner for the Internal Market and Services, Fritz Bolkestein, was quoted as saying, “Section 106 requires all big EU audit firms to register with the proposed Board, pay registration fees, apply US rules on auditing, ethics, and quality control, and subject themselves to the investigative and disciplinary sanctions of the Board and US authorities.”<sup>33</sup> He also expressed uneasiness about requiring European Union accounting firms to simultaneously abide by both EU and U.S. securities laws. This concern can certainly be extrapolated to other nations and the difficulties they will face conforming to both the U.S. and their domestic regulatory systems.

An illustrative example clarifies the implication of section 106 and will convey further meaning to the demand of SOX on foreign firms. Consider if U.S. Firm X audits a large, multinational company that holds a foreign subsidiary in the European Union and is registered on a U.S. stock exchange. Firm Y, operating under the laws of the EU, assists Firm X in its audit of the company by performing the testing of the foreign subsidiary’s internal controls. Under the Sarbanes-Oxley Act, Firm Y must register with the PCAOB if any of its audit work is to be relied upon for the purpose of Firm X’s audit of the U.S. listed corporation.

Consequently, Firm Y, during the course of its registration with the PCAOB and future compliance with SOX, may find itself in the unfavorable position of complying with two legal systems simultaneously. Furthermore, Firm Y may find that it cannot

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<sup>33</sup> Eu Warns on Sarbanes - Oxley Act. *Financial News (Daily)*, September 6, 2002.

comply with both countries' laws at the same time due to their inherently conflicting nature. In the latter case, does Firm Y choose to follow the laws of the country it operates within or the laws of a foreign country? One source interestingly declares, "Through its ability to register all firms that audit public companies, including foreign auditors, [...] the PCAOB will be able to regulate both national and foreign audit firms involved in the U.S. securities market."<sup>34</sup> It is this power, among many others, possessed by the PCAOB that has led foreign firms to protest Sarbanes-Oxley and question its effectiveness in relation to international auditors.

### *Sarbanes-Oxley & the Accounting Profession*

Before the PCAOB emerged in the United States under Sarbanes-Oxley, the accounting profession was responsible for the both its own regulation and funding of this regulation.<sup>35</sup> The American Institute of Certified Public Accountants (AICPA) is the national association for U.S. public accountants. Prior to Sarbanes-Oxley, the AICPA issued and enforced a code of conduct by which accountants upheld. After the PCAOB was founded, oversight of public accountants in the U.S. became separated by law from the accounting profession. Regulation of the fields of accounting and law in the past has differed greatly from the regulation of other industries and professions. In the aftermath of the accounting scandals, however, it became apparent to lawmakers that drastic change was needed.<sup>36</sup> One source summarizes this change by saying, "Consequently, by implementing provisions such as board audit committees, auditor service restrictions, and

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<sup>34</sup> Giles, Jill P., Elizabeth K. Venuti, and Richard C. Jones. "The PCAOB and Convergence of the Global Auditing and Accounting Profession." *The CPA Journal* 74, no. 9 (Sep, 2004): 36.

<sup>35</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>36</sup> Ibid.

attorney conduct standards, SOX bridged the long standing divide between federal securities regulation, state corporate governance law, and professional self-regulation.”<sup>37</sup>

Effectively, Sarbanes-Oxley in one swift swoop turned the former self-regulating accounting profession upside down and transformed it into a rule-centered profession that operates under the constant supervision of the PCAOB. The accounting industry’s dissatisfaction with this change is rather apparent given the PCAOB’s nickname, “Peekaboo,” referring to its constant monitoring of the industry’s actions. *The CPA Journal* conducted a survey of auditing professionals about Sarbanes-Oxley and the role of the PCAOB after a few years had passed since the Act’s creation. This source reports one respondent as saying: “I think that there is an expectations gap here. Even if we get financial reporting 99.9% accurate, that 0.1% will still generate enough headlines and bad press to keep accounting problems in the news. So then, how effective is SOX in reality to the profession?”<sup>38</sup> While the future of the newly created Board is not certain, it is widely recognized that the PCAOB plays a significant role in the accounting industry worldwide, regardless of its acceptance among professionals.<sup>39</sup>

Apart from the regulation of public accountants, the overall impact on the accounting industry and its practices is far-reaching. While the purpose of this study is not to perform an in-depth analysis of Sarbanes-Oxley in its entirety, it is necessary to identify the significant areas of the law that impact both U.S. and foreign accounting practices. The five primary areas in which SOX changes prior practices are: (1) The relationship between audit committees and their external auditors; (2) Auditor

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<sup>37</sup> Ibid.

<sup>38</sup> PCAOB-Beyond the First Year. *Mondaq Business Briefing*, July 15, 2004.

<sup>39</sup> Hill, Nancy T., John E. McEnroe, and Kevin T. Stevens. "Auditors' Reactions to Sarbanes-Oxley." *The CPA Journal* 77, no. 7 (Jul, 2007): 6.

independence and services allowed; (3) Mandatory auditor internal control assessment; (4) Management internal control assessment; and (5) Document retention.<sup>40</sup>

Additionally, another source notes the added disclosures now required of firms and the threat of criminal punishment have also drastically affected the industry.<sup>41</sup> These new practices have been difficult and costly for U.S. firms to implement into their operations.

Furthermore, the differences that existed between the U.S. and foreign accounting industries have made it all the more difficult for those foreign companies and firms under the reach of SOX to implement these practices. For example, David Sun, a partner-in-charge of assurance and advisory for Ernst and Young Asia-Pacific commented on the difficulty of complying with auditor rotation requirements, a tenet designed to ensure auditor independence. *International Securities Outlook Online* states, "Sun said that the SEC's proposals would not work in many Asian countries without affecting audit quality. Asian countries are unable to train accountants fast enough to keep pace with their economic development."<sup>42</sup> Because the stage of development of the accounting profession varies from region to region, it proves difficult to implement the auditor rotation requirement mandated by SOX. For instance, the ratios of auditors to people in the United States and China are 1:1,000 and 1:13,000, respectively.<sup>43</sup> This enormous

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<sup>40</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>41</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>42</sup> "Foreign Securities Regulators Express Concern about Auditor Independence Rules." *International Securities Outlook Online* Volume 4, Issue 1 (January 6, 2003, 2003): December 1, 2007, <http://business.cch.com>.

<sup>43</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).



difference demonstrates the general rigidity of SOX and the difficulty of putting its decrees into practice outside of the U.S.

Additionally, the intrinsic disparities that exist between the U.S. rule-centered accounting system and the European principles-based system lead many abroad to reject the imposition of SOX. In fact, many Europeans are of the mindset that the rule-based system is largely responsible for allowing the occurrence of the accounting scandals in the first place.<sup>44</sup> There have been many requests submitted to the SEC, primarily from Europe, asking for regulators around the world to develop a universal principles accounting system.<sup>45</sup> This would allow for a coherent worldwide system to develop in place of a system where accountants must reconcile to a number of different regulatory systems. Former SEC commissioner, Roel Campos, has made it clear, according to one source, that the SEC does not intend “to hold foreign participants in the U.S. market to a higher level of regulation or review than the level to which we hold U.S.-based participants.”<sup>46</sup> While this may in fact be the case, adherence to multiple regulatory environments is a reality for foreign entities. This reality has only been worsened by Sarbanes-Oxley and foreign market participants are certainly feeling the effects of it.

### *Compliance & Inspection*

Apart from considerable registration and annual membership fees, the costs of putting Sarbanes-Oxley into practice is substantial for both U.S. listed companies and the accounting firms auditing them. These heightened costs create an obvious disadvantage

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<sup>44</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

<sup>45</sup> "Foreign Securities Regulators Express Concern about Auditor Independence Rules." International Securities Outlook Online Volume 4, Issue 1 (January 6, 2003, 2003): December 1, 2007, <http://business.cch.com>.

<sup>46</sup> Text: Rules Changes Will Bolster Confidence, SEC Commissioner Says; Changes Treat Foreign and Domestic Companies Equally, Campos Adds. *State Department*, June 12, 2003.

for smaller firms with limited resources as well as foreign firms, who now face the costs of multiple regulatory bodies.<sup>47</sup> Additionally, not all of the costs of Sarbanes-Oxley with respect to foreign firms are monetary. The ramifications of subjecting foreign firms to produce its workpapers or undergo U.S. inspection are by no means purely fiscal. Rather, these requirements put foreign firms in the unfavorable position of potentially violating their home country laws in order to comply with SOX.

Where information that is considered confidential under one nation's law is now required to be produced under U.S. law, conflict of law is imminent and the cost to foreign firms is detrimental.<sup>48</sup> Ethiopis Tafara, Director of the Office of International Affairs for the SEC, explained the position of the Commission during a speech in London. On the production of workpapers and conflict of laws, he states, "Non-production of the papers and delays can significantly impede an enforcement program. While [the SEC] certainly respect[s] foreign laws, national boundaries cannot serve to shield foreign participants in the US market from investigation."<sup>49</sup> Paragraph (c) of Section 106 grants power to the PCAOB to grant exemptions to foreign governments when appropriate. Many foreign opponents to the Act have called upon the Board for workpaper exemption among others, but the Board has not granted this request to date in the interest of investors.<sup>50</sup> Debate over U.S. enforcement of SOX abroad and the different business and legal structures across the world has been a hot topic. The PCAOB

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<sup>47</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>48</sup> Ibid.

<sup>49</sup> Tafara, Ethiopis. "Speech by SEC Staff: U.S. Perspective on Accountancy Regulation and Reforms by Ethiopis Tafara." London, U.S. Securities and Exchange Commission, July 8, 2003, 2003, <http://www.sec.gov/news/speech/spch070803et.htm> (accessed December, 1 2007).

<sup>50</sup> Miller, Richard I. and Paul H. Pashkoff. "Regulations Under the Sarbanes-Oxley Act." *Journal of Accountancy* 194, no. 4 (Oct, 2002): 33.

will need to find a solution for foreign registrants and address how it intends to conduct its regulatory activities outside U.S. borders.<sup>51</sup>

Under Sarbanes-Oxley, the PCAOB holds the power to inspect registrants and their auditing procedures regardless of nationality. If a firm is found in violation of a SOX tenet, the Board can issue a number of sanctions. The ultimate sanction the PCAOB can utilize involves revoking a firm's registration status, thereby preventing that firm from auditing public companies listed on U.S. capital markets.<sup>52</sup> One source states that the "PCAOB's inspections of registered audit firms are intended to assess the degree of audit firms' compliance with audit standards in conducting audits. These inspections may be very thorough, and could entail discussions with audit clients and restatements in the event accounting errors are discovered."<sup>53</sup> In addition to existing SEC regulations already followed by foreign companies, SOX now introduces a regular schedule of inspection for compliance purposes as well as inspections when firm conduct is in question.<sup>54</sup>

In lieu of a PCAOB inspection, foreign accounting firms may have the option of having a domestic regulatory body conduct the inspection. However, the decision of the PCAOB to rely on the foreign regulatory body's inspection results will heavily weigh on the integrity of the system as perceived by the Board.<sup>55</sup> The PCAOB has been

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<sup>51</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>52</sup> Ibid.

<sup>53</sup> Better Governance and Reporting Under Sarbanes - Oxley : Are we there Yet? *Mondaq Business Briefing*, November 23, 2004.

<sup>54</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>55</sup> Better Governance and Reporting Under Sarbanes - Oxley : Are we there Yet? *Mondaq Business Briefing*, November 23, 2004.

collaborating with foreign regulators to explore the possibility of conducting joint inspections to improve cost and efficiency of SOX compliance across borders, but the outcome of these efforts have yet to be determined.<sup>56</sup> Finally, if the Board does in fact accept the inspection of foreign firms by foreign regulatory bodies, the question still remains as to the treatment of those firms found in violation of SOX practices. As one source notes, “Although imprisonment and fines are penalties integrated into the Act, it remains to be seen how, and for what provisions, the SEC will apply these sanctions to foreign violators.”<sup>57</sup> Even if the PCAOB is able to develop a compatible system of inspection abroad, it still has not addressed the manner in which it intends to enforce SOX for accounting firms operating within foreign borders found to be in violation of the U.S. law.

## PART II

### *History of U.S. Securities Law*

Sarbanes-Oxley has been said to be the most significant piece of securities reform legislation since the 1933 and 1934 Securities Acts, which were created to prevent another stock market crash like that of 1929. In order to see why Sarbanes-Oxley has received such negative reaction internationally, one must first understand the basics of U.S. securities law and how it has previously been applied to international entities. Prior to SOX, the SEC and U.S. courts in conjunction established a framework that achieved

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<sup>56</sup> Tafara, Ethiopis. "Speech by SEC Staff: U.S. Perspective on Accountancy Regulation and Reforms by Ethiopis Tafara." London, U.S. Securities and Exchange Commission, July 8, 2003, 2003, <http://www.sec.gov/news/speech/spch070803et.htm> (accessed December, 1 2007).

<sup>57</sup> "COMMENT: WAS ITS BITE WORSE THAN ITS BARK? THE COSTS SARBANES - OXLEY IMPOSES ON GERMAN ISSUERS MAY TRANSLATE INTO COSTS TO THE UNITED STATES." 2004 *Emory University School of Law Emory International Law Review* (Spring, 2004).

foreign compliance with U.S. regulations while still honoring the laws of their domestic governments.<sup>58</sup> SOX does not destroy this loose framework, but it does threaten to tip the historical balance by not respecting the laws and institutions, mainly those involving accounting oversight, of countries abroad.

Regulation S was the SEC's first significant step to address foreign concerns about SEC foreign registration requirements for securities transactions under the Securities Act of 1933.<sup>59</sup> The SEC's issuance of Regulations S provided additional information to foreign companies with respect to registering for U.S. capital market access while ensuring that the autonomy of their domestic governments was still honored.<sup>60</sup> The purpose of the SEC is to protect U.S. investors from fraudulent business actions, thereby providing a secure capital market environment in the United States. As a result, protecting investors from fraud is often said to be the defining characteristic of U.S. securities law, which consequently affects investors from all over the globe.<sup>61</sup>

To determine whether fraudulent behavior has occurred and also whether the United States has jurisdiction of the matter in question, the U.S. courts have developed two tests for their decision-making process: Effects and Conduct.<sup>62</sup> The application of these tests historically has determined whether the U.S. should pursue extraterritorial enforcement of its securities laws. The idea behind the tests is to essentially limit U.S. pursuit of claims regarding securities law violations outside its sovereign borders.<sup>63</sup> This

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<sup>58</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>59</sup> Ibid.

<sup>60</sup> Ibid.

<sup>61</sup> Ibid.

<sup>62</sup> Ibid.

<sup>63</sup> Ibid.

format provides a cohesive manner in which courts determine whether subject matter jurisdiction applies outside of U.S. borders. In addition, the tests limit the amount that the U.S. can impose its laws and subsequent penalties on foreign citizens and corporations.<sup>64</sup>

The SEC threw away its traditional accommodations for foreign issuers with respect to securities legislation when SOX was issued. Although the SEC has granted some degree of exemption to foreign firms from Sarbanes-Oxley, the international feeling toward the law is still unfavorable and many are confused by the United States' divergence from its historical method of regulation for international entities. One source believes that "much of this confusion is attributable to a widening gap between the original premise of the U.S. securities laws in relation to foreign issues and the new reality of globalization."<sup>65</sup> Although in the past there have been instances in which the SEC has taken action against foreign issuers, especially with respect to anti-fraud legislation, non-U.S. companies take these limited occurrences into account when deciding whether or not to list on U.S. exchanges.<sup>66</sup> Historically, the risk of answering to the U.S. Courts for securities law violation has not deterred the entrance of foreign firms into the market. However, one must wonder if Sarbanes-Oxley and its heightened risk of U.S. enforcement abroad will now push foreign companies away from the U.S. capital market.

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<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> "COMMENT: WAS ITS BITE WORSE THAN ITS BARK? THE COSTS SARBANES - OXLEY IMPOSES ON GERMAN ISSUERS MAY TRANSLATE INTO COSTS TO THE UNITED STATES." 2004 *Emory University School of Law Emory International Law Review* (Spring, 2004).

### *International Challenges of Sarbanes-Oxley*

The international outrage toward Sarbanes-Oxley is best summarized by the following statement: “SOX reaches beyond the registration and disclosure requirements first established by the 1933 and 1934 Acts and forces foreign corporations to conform to a model of corporate governance crafted by the U.S. Congress.”<sup>67</sup> Those who object to the Act are wary of the increasing reach of the SEC and newly created PCAOB. International concern primarily stems from Section 106 and there is a call to allow foreign exemptions for those firms that are cross-listed on U.S. exchanges.<sup>68</sup> Many critics emphasize that they believe in the overall purpose of Sarbanes-Oxley, but do not support the tedious requirements now demanded of foreign corporations.

Another common reaction to SOX is that many believe it was created to clean up the mess of scandals that occurred in the U.S. during 2002 and that foreign firms should not have to suffer the consequences of cleaning up the U.S. system. One source believes that “extending this regulation beyond US firms is seen as an arrogant imposition from American regulators.”<sup>69</sup> The negative foreign opinion stems from the fact that U.S. firms gain the upper hand over international accounting firms who now must answer to multiple regulatory systems. Disapproval of SOX is especially prevalent in the European Union, where governments are currently trying to merge several economies, all with differing laws and regulatory bodies, into a single, unified EU economic system.<sup>70</sup>

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<sup>67</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>68</sup> Quinn, Eamon. Accountants Step Up Bid Against Us Law. *Sunday Business Post*, September 15, 2002.

<sup>69</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

<sup>70</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

Sarbanes-Oxley essentially deepens this burden for the EU and the U.S. could possibly face future repercussions from the EU if it were to unify.

Answering to more than one accounting regulation system is an extreme disadvantage for foreign firms and representatives of the Big Four Accounting firms abroad have readily voiced their dissatisfaction with the new law. Aidan Walsh, an executive of KPMG International, has said that SOX has made it tricky for the firm to implement abroad and believes that “the Act was put together hastily and with little regard for the consequences to companies based outside of the US.”<sup>71</sup> A European partner at PriceWaterhouseCoopers echoes a similar attitude toward SOX and explains international opposition by stating, “No one wants to be a copy of the US. If there is any country where something has gone wrong in the field of corporate governance, and accounting and capital markets, it’s the US.”<sup>72</sup> Consequently, the international community is now beginning to wonder if the U.S. capital market is really the place to invest if companies are now forced to comply with a law that puts them at an inherent disadvantage in the marketplace.<sup>73</sup>

In some ways, it is surprising that there is such opposition abroad because foreign corporations have traditionally followed U.S. securities laws for years in the past. A careful look into the legal framework of securities regulation provides valuable insight into this apparent anomaly. Although the creation of Regulation S, as mentioned in the preceding section, calmed securities registration worries abroad, fraud regulation, despite

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<sup>71</sup> Kemp, Shirley. Us Laws to Hinder Sa Companies. *Moneyweb (South Africa)* - AAGM, November 5, 2002.

<sup>72</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

<sup>73</sup> Kemp, Shirley. Us Laws to Hinder Sa Companies. *Moneyweb (South Africa)* - AAGM, November 5, 2002.



the tests developed by the U.S. Courts, still creates unstable conditions in the international marketplace.<sup>74</sup> Despite the initial tendency of many to believe that SOX drastically disrupts this already shaky balance, in reality this is not the case.

In fact, the tenets of SOX that specifically refer to its international application entirely relate to the activity of those firms already registered on the U.S. capital market.<sup>75</sup> Ironically, SOX technically falls under the guidance of Regulation S and its specific rules regarding international entities. Regulation S is essentially the weight that keeps the unstable investment environment in balance by respecting international sovereignty and calming international compliance concerns.<sup>76</sup> This leads one to conclude that Sarbanes-Oxley would not tip the historic balance and this conclusion could not be farther from the truth.

It is important to emphasize that the Act does not impose its requirements on just any international party. SOX simply affects those foreign firms already registered on the U.S. market, or choose to register in the future, and are voluntarily complying with existing U.S. securities laws.<sup>77</sup> Although compliance is an additional cost associated with access to U.S. stock exchanges, as long as international firms continue to feel as though the benefits of the U.S. market exceed the costs listed firms face, they will likely maintain their listing in the U.S.<sup>78</sup> Since the issuance of SOX, however, the sudden decrease in foreign listings on the market in the United States suggests that foreign firms are now

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<sup>74</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>75</sup> Ibid.

<sup>76</sup> Ibid.

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

perceiving the costs of listing to be in excess of the benefits.<sup>79</sup> Foreign de-listing creates a lose-lose situation for U.S. citizens and foreigners alike and ultimately makes it possible to conclude that the imposition of U.S. laws on foreign corporations is not in anyone's best interest.

The major issue international critics have with Sarbanes-Oxley concerns its corporate governance rules.<sup>80</sup> It is believed that Title III of the Act, titled Corporate Responsibility, is largely responsible for pushing foreign companies to either de-list from U.S. exchanges or decide not to enter the market in the first place. The critics believe that it was one thing to voluntarily follow past requirements to participate in the U.S. market, which primarily consisted of providing in-depth earnings information to regulators, but quite another to require that foreign companies rearrange their corporations in order to continue to list in the U.S.<sup>81</sup> One source summarizes this conflict and explains, "Since controlling shareholders and banks have traditionally kept a closer watch on management in many foreign countries, much of the management-centered U.S. approach, such as strict disclosure of management self-interest and compensation, may be too oppressive and unnecessary in the case of foreign companies."<sup>82</sup> The intrinsic differences embedded in corporate architecture across different nations imply that the one size fits all mentality of Sarbanes-Oxley is not realistic for international companies.

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<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

<sup>82</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." 2003 *Columbia Law School Columbia Business Law Review* (2003).

The nature of SOX promotes an individualistic business environment that naturally conflicts with those nations whose cultures promote a collective environment.<sup>83</sup> This environmental variance is particularly true of Germany and Japan, two nations who possess a strong economic presence in the United States.<sup>84</sup> Because SOX regulations were created with the intention to protect U.S. investors and U.S. corporations promote individual accountability, the regulations were designed to control for individual behavior. On the other hand, Germany, whose market capitalization and foreign direct investment in the U.S. are approximately \$287 billion and \$35 billion, respectively, designed its corporate structure to reflect shared accountability. Shared accountability reflects Germany's collectivist culture.<sup>85</sup> An issue now arises because German companies who list on U.S. exchanges are now subject to the regulations created under SOX. Conflict will inevitably occur when imposing an individualistic regulation on a collectivist company. The two-tier board structure of German corporations would make it nearly impossible to comply with the independence requirements under SOX and lacks a CEO figure to certify the company's financial statements.<sup>86</sup> The rigid nature of Sarbanes-Oxley, its indifference toward foreign nations, and the subsequent culture clashes, generate additional animosity toward the U.S.

Another interesting challenge resulting from the imposition of SOX abroad is the inability to accurately translate some of the terms mentioned in the Act into certain

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<sup>83</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>84</sup> Ibid.

<sup>85</sup> Ibid.

<sup>86</sup> Ibid.

foreign languages.<sup>87</sup> This is a direct result of the cultural differences and variable business norms that exist around the world. Even if some of the phrases used in SOX are literally translated into a foreign language, the phrases will still lack meaning abroad because the context is unique to the U.S. business culture. To illustrate, translation of SOX into the Japanese language has proved difficult because Japan is another culture that promotes a collective mentality.<sup>88</sup> The term “officers” does not transfer to Japanese business terminology because this culture encourages companies to have boards that work together to govern corporations. Therefore, the requirements of SOX that demand “officers” to act in a specific manner and the individual accountability of management in the U.S. have little or no meaning to the Japanese business culture.<sup>89</sup> Additionally, the process used in Japan to select external auditors differs from U.S. practice and directly conflicts with the stringent independence standards under SOX. Because Japan allows its shareholders to directly determine the external auditor for each company and the U.S. mandates independent audit committees to make the decision, there is another culture clash.<sup>90</sup> Imposition of SOX independence standards on Japanese countries would override the cultural norms inherent to Japanese business processes.

Ongoing negotiations between the SEC, PCAOB, and foreign representatives provide hope that the U.S. will soon compromise certain provisions of Sarbanes-Oxley to better suit international needs, such as corporate governance tenets, which differ in many instances from the U.S.<sup>91</sup> The SEC and PCAOB have listened to these international

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<sup>87</sup> Ibid.

<sup>88</sup> Ibid.

<sup>89</sup> Ibid.

<sup>90</sup> Ibid.

<sup>91</sup> Hope of further Compromise with the SEC. *International Accounting Bulletin*, January 24, 2003. 8.

concerns and have since responded in the following ways: (1) Granted permission to follow domestic corporate governance structure provided foreign firms complete a mandatory disclosure of the differences between the domestic structure and that of the U.S.; (2) Exceptions have been granted in limited cases when the Act's provisions have conflicted with international laws, but never with respect to audit committee requirements; (3) Extended initial PCAOB registration deadline for foreign firms to July 19, 2004; (4) Foreign firms are permitted to withhold sensitive information when registering with the Board if it is in conflict with their home country's laws. The firms must complete an extensive disclosure statement explaining the need to withhold the information from the Board in order to be granted the exemption; and (5) The PCAOB is collaborating with foreign regulators to conduct inspections abroad on its behalf.<sup>92</sup> While these exemptions for foreign firms are a good start, the PCAOB and SEC still have a long way to go in order to diffuse international concerns.

The permission granted to foreign accounting firms to withhold information from the Board that would violate its domestic laws was a significant step. However, the process of earning this allowance is not as simple as it appears for foreign companies. Foreign entities now must endure a lengthy process of consents and waivers to obtain this exemption, at a cost inevitably passed onto the foreign accounting firms.<sup>93</sup> Additionally, while the SEC has granted some relief to foreign companies under the controversial Title III by allowing home country practice to have precedence, it still mandates certain practices difficult to implement under foreign law, such as the audit committee

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<sup>92</sup> Better Governance and Reporting Under Sarbanes - Oxley : Are we there Yet? *Mondaq Business Briefing*, November 23, 2004.

<sup>93</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

provisions.<sup>94</sup> Finally, the decision of the PCAOB to extend the registration deadline for foreign accounting firms and exempt those firms from providing certain information normally required for registration but in violation of international laws was another considerable step for the Board. However, the disclosure process to obtain this exemption is again timely and costly for foreign firms, further deepening the disadvantages faced by foreign companies in comparison to U.S. firms.<sup>95</sup>

### PART III

#### *Economic Impact*

Foreign presence in the U.S. capital market has grown considerably in the past three decades and non-U.S. companies' capital is vital to the health of the U.S. economy.<sup>96</sup> The composition of the market, consisting of U.S. and foreign listed companies, has impacted SEC procedures and resulted in U.S. dependency on foreign market participation. Former SEC Commissioner Roel Campos addressed the Center for European Policy Studies in Brussels on June 11, 2003 to discuss the importance of foreign companies to the U.S. market.<sup>97</sup> During this speech, Campos encourages foreign participation provided the companies were prepared to comply with the SEC and its intent to protect investor interest.

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<sup>94</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

<sup>95</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>96</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

<sup>97</sup> Text: Rules Changes Will Bolster Confidence, SEC Commissioner Says; Changes Treat Foreign and Domestic Companies Equally, Campos Adds. *State Department*, June 12, 2003.

The former Commissioner acknowledges his presence in Europe as a means of opening dialogue to find a way to maintain, or even expand, the number of foreign issuers on the U.S. market while still achieving the SEC's principal goal of protecting investors.<sup>98</sup> Campos' speech stresses the benefits of having foreign companies listed on U.S. exchanges and says the Commission is working to strike a balance between foreign participation and investor protection. He states, "Shielding U.S. firms from foreign competition, however, would deprive U.S. investors of the benefits derived from the services and products offered by non-U.S. competitors. [The SEC] also would do [the] economy a great disservice if we were to shelter our issuers, markets and intermediaries from competition. We are striving for a balance that will result in fair, reasonable, and efficient markets."<sup>99</sup> In order to maintain a healthy economy, it is in the best interest of the United States for the SEC to discover this balance as soon as possible.

The number of foreign companies registering on the U.S. capital market has significantly declined since the release of SOX late in 2002.<sup>100</sup> It appears that foreign corporations are beginning to believe that the costs of complying with the Act now exceed the benefits of the U.S. market.<sup>101</sup> This will ultimately impact the economic situation in the U.S. and, as capital moves to markets located outside of the U.S., places the country at a severe disadvantage. The hindrance SOX is causing to the economy by impairing the desirability of the U.S. market to foreign companies is hurting the economy

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<sup>98</sup> Ibid.

<sup>99</sup> Ibid.

<sup>100</sup> Kemp, Shirley. Us Laws to Hinder Sa Companies. *Moneyweb (South Africa) - AAGM*, November 5, 2002.

<sup>101</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

in a time when it is still suffering the effects of the accounting scandals and also the war in Iraq.<sup>102</sup>

Another source notes that, with respect to application of U.S. securities legislation to international entities, “the SEC has traditionally been lenient in subjecting non-U.S. issuers to new requirements by liberally granting exemptions from various provisions.”<sup>103</sup> Sarbanes-Oxley has been the exception to this norm, generating outrage from the international business community and creating impediments to a healthy economy. Critics have even charged the U.S. as attempting to act as a “global regulator” of securities and insist that SOX creates an “anti-competitive” environment that denies foreign firms access to the same economic opportunities as U.S. companies.<sup>104</sup> Although the U.S. market has historically generated great wealth for listed companies and their investors, there is concern that the “biggest pool of capital on earth” may no longer be characteristic of the U.S. market if foreign firms look elsewhere to list in order to avoid the implications of the Act.<sup>105</sup>

The potential for Sarbanes-Oxley to have “a chilling impact on transnational trade” for the U.S. has led many corporations to examine the attractiveness of foreign stock exchanges in lieu of U.S. exchanges.<sup>106</sup> The simple fact that the Act is causing corporations to pursue listings outside of the U.S. in order to avoid intensive and costly

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<sup>102</sup> Kemp, Shirley. Us Laws to Hinder Sa Companies. *Moneyweb (South Africa)* - AAGM, November 5, 2002.

<sup>103</sup> "COMMENT: WAS ITS BITE WORSE THAN ITS BARK? THE COSTS SARBANES - OXLEY IMPOSES ON GERMAN ISSUERS MAY TRANSLATE INTO COSTS TO THE UNITED STATES." 2004 *Emory University School of Law Emory International Law Review* (Spring, 2004).

<sup>104</sup> "Note:Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." 2004 *George Washington University George Washington International Law Review* (2004).

<sup>105</sup> Ibid.

<sup>106</sup> "Note:Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." 2004 *George Washington University George Washington International Law Review* (2004).



regulation proves that Sarbanes-Oxley is not necessarily the key to the problems of the world's accounting system.<sup>107</sup> Furthermore, it is becoming very apparent that this legislation is intensifying the economic downturn in the United States and the economy will continue to worsen as foreign companies decide to de-list as a means of avoiding the reach of SOX.<sup>108</sup> As mentioned before, the decision to list on capital markets involves a careful cost-benefit analysis. The costs associated with listing on stock exchanges result from regulation and compliance costs.<sup>109</sup> It is these costs that allow listed companies to access the benefits of the markets and the wealth they seek to obtain. The strict regulation of markets works to prevent fraud and provide investors with the highest amount of protection available.<sup>110</sup> In the past, the U.S. capital market consistently produced benefits that outweighed the costs of regulation. This was the case until the Sarbanes-Oxley, however now the market's benefits "are suddenly obscured by the intrusion of the highly developed and complex U.S. regulatory regime."<sup>111</sup>

Consequently, U.S. stock exchanges are now left to address the decline in foreign company participation in the market, a component that has been vital to the strength of the U.S. economy during the rise in globalization.<sup>112</sup> European companies are a vital component of the U.S. economy but, at the same time, are strongly opposed to the

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<sup>107</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>108</sup> Ibid.

<sup>109</sup> "COMMENT: WAS ITS BITE WORSE THAN ITS BARK? THE COSTS SARBANES - OXLEY IMPOSES ON GERMAN ISSUERS MAY TRANSLATE INTO COSTS TO THE UNITED STATES." *2004 Emory University School of Law Emory International Law Review* (Spring, 2004).

<sup>110</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>111</sup> Ibid.

<sup>112</sup> Newman, Bernard H. and Mary Ellen Oliverio. "Perceived Flaws in Sarbanes-Oxley Implementation." *The CPA Journal* 76, no. 9 (Sep, 2006): 6.

implications of the Act. In reality, the problem SOX poses for European companies could indeed be the motivator the EU needs to knock down national barriers and political differences it struggles with in order to form a unified EU economy, complete with its own securities and oversight institutions.<sup>113</sup> This unification could mean trouble for the U.S. because it would face an economy closer to its size and level of power. Additionally, the U.S. could potentially find itself in the unfavorable position of answering to multiple regulatory regimes if the EU decides to require non-EU firms listed on EU exchanges to comply with its regulations.

The U.S. will need to continue to watch foreign reactions to Sarbanes-Oxley and international acceptance of its securities regulations, especially since the London Stock Exchange has begun to advertise its market as a favorable alternative to U.S. exchanges.<sup>114</sup> A Wall Street Journal article notes, "A recent London Stock Exchange survey of 80 international companies that went public on its markets found that of those that had contemplated a U.S. listing, 90% decided Sarbanes-Oxley made London more attractive."<sup>115</sup> German car manufacturer Porsche revealed that Section 906 of the Act, which addresses mandatory CEO/CFO certification of financial statements, is the primary cause of its decision not to register as planned on the New York Stock Exchange.<sup>116</sup> Porsche believes that the collectivist system of management, which reflects the essence of German culture, does not place the same value on a CEO or CFO in the company and its management system would not be compatible with the system of management

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<sup>113</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

<sup>114</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

<sup>115</sup> "Peekaboo Powers." *Wall Street Journal*, Feb 8, 2006.

<sup>116</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

described in SOX.<sup>117</sup> In addition to Porsche, the Japanese company Daiwa, has also decided to wait to list on the NYSE exchange.<sup>118</sup> In support of its decision, Daiwa states, “We didn’t know what the rules of the game we’d be playing would be.”<sup>119</sup> Daiwa executives chose to not enter the U.S. market to avoid subjecting the company to SOX before it was evident how it would impact international companies. If the U.S. continues down this path and does not address the significant impact of SOX on the U.S. economy, one source predicts that the result will create “a bite far worse than the bark of Sarbanes-Oxley.”<sup>120</sup>

### *Legal Impact*

Sarbanes-Oxley has also had significant impact on the scope of U.S. law and the legal profession since its creation. One source states, “Such international application of Sarbanes-Oxley creates issues such as duplication of regulatory burdens, inconsistent regulatory requirements and laws, cultural differences, and concerns of sovereignty and comity.”<sup>121</sup> Foreign companies listed in the United States will be subject to the U.S. courts system per the Act, an issue that generates more negative reactions abroad and produces accusations that the U.S. is interfering with foreign nations’ freedom from outside intervention and their right to self-govern.<sup>122</sup> The potential for legal conflict is endless for foreign entities under SOX. Answering to multiple regulatory regimes

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<sup>117</sup> Ibid.

<sup>118</sup> “Note: Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality.” 2004 *George Washington University George Washington International Law Review* (2004).

<sup>119</sup> Ibid.

<sup>120</sup> “COMMENT: WAS ITS BITE WORSE THAN ITS BARK? THE COSTS SARBANES - OXLEY IMPOSES ON GERMAN ISSUERS MAY TRANSLATE INTO COSTS TO THE UNITED STATES.” 2004 *Emory University School of Law Emory International Law Review* (Spring, 2004).

<sup>121</sup> Better Governance and Reporting Under Sarbanes - Oxley : Are we there Yet? *Mondaq Business Briefing*, November 23, 2004.

<sup>122</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

ultimately means that firms must adhere to multiple laws and the subsequent enforcement of the laws. KPMG “warned of legal impediments to transnational oversight and discipline” and is concerned that double jeopardy could come into play if an auditor is prosecuted both in its home country as well as in the U.S. for violating each nations’ respective laws.<sup>123</sup>

It has been traditional practice and characteristic of basic foreign diplomacy to not apply domestic laws extra-territorially. Former Supreme Court Chief Justice Rehnquist has spoken against extraterritorial reach of the law because disallowing it permits nations around the world to respectively co-exist in peace with one another.<sup>124</sup> When this respect is not granted, tension erupts between governments around the world. Former Supreme Court Justice Holmes, a notable American judge who was on the Supreme Court from 1902 to 1932, once said, “The general and almost universal rule is that the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done.”<sup>125</sup> That said, the intent of Sarbanes-Oxley to expand the reach of this Act to foreign corporations and accounting firms operating under the laws of another nation goes against this bedrock principal of one of America’s most respected judges.

In the most extreme cases, there have been a limited number of situations in which the extraterritorial application of one nation’s law onto another’s has been warranted. In order to preserve U.S. foreign relations, the Courts have devised a process to determine whether such an extreme situation exists to apply a U.S. law outside

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<sup>123</sup> Cheney, Glenn. "Uncle Sam Kicks Ass." *Australian CPA* 74, no. 3 (Apr, 2004): 29.

<sup>124</sup> "Note: Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." *2004 George Washington University George Washington International Law Review* (2004).

<sup>125</sup> Ibid.

sovereign borders.<sup>126</sup> The Effects Test previously mentioned in PART II determines if the U.S. has subject matter jurisdiction to pursue a claim internationally.<sup>127</sup> Additionally, the courts test for the reasonableness of the claim, weighing the interests of both nations involved, and this test is known as the Restatement Test.<sup>128</sup> This test evaluates eight factors, which are:

- (1) Substantiality of effect;
- (2) The connections of the defendant with the forum;
- (3) Character of the activity;
- (4) Existence of justified expectations;
- (5) Importance of regulation;
- (6) Extent to which the regulation is with international norms;
- (7) Extent to which another state may have an interest in regulating the activity;
- (8) The likelihood of conflict with another nation.<sup>129</sup>

Applying the Restatement Test to enforcing Sarbanes-Oxley abroad, it is not warranted to impose this legislation outside U.S. borders, mainly due to the strong weight of the final two factors of the test.<sup>130</sup> Evaluation of the seventh factor does not support extraterritorial reach because accounting oversight is not unique to the United States. There are in fact other nations who possess a strong interest in accounting oversight of their domestic corporations and accounting firms, meaning these nations possess laws of their own to enforce. In addition, because foreign nations have their own regulatory institutions for oversight, imposition of the U.S. oversight system would invade their domestic institutions and threaten to create conflict from U.S. intrusion.

Utilizing numerous theoretical models developed both under the law and within the academic arena, the same conclusion is reached: The extraterritorial application of

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<sup>126</sup> Ibid.

<sup>127</sup> Ibid.

<sup>128</sup> Ibid.

<sup>129</sup> Ibid.

<sup>130</sup> Ibid.

Sarbanes-Oxley has no legitimacy and violates fundamental tenets of international relations.<sup>131</sup> In order to avoid conflict with other nations, and their respective laws and institutions, Sarbanes-Oxley should not be imposed on non-U.S. companies to the extent it originally allows. Aside from its apparent lack of extraterritorial legitimacy, SOX would also cause problems because the legal environments of foreign nations differ greatly from that of the U.S.<sup>132</sup> The U.S. legal system is comprised of both civil and common law. However, in other countries throughout the world, legal systems only have civil laws.<sup>133</sup>

This distinction is important because of the manner in which common laws are created. Previous legal disputes and their subsequent verdicts create precedence, thus forming the basis for the common law system.<sup>134</sup> With respect to SOX, an important common law that has substantially evolved over time refers to professional duty of care. This common law ultimately exists to protect investors and legally hold professionals to provide a minimal level of care in their conduct.<sup>135</sup> In those countries that operate only under a civil law system, however, this protection is provided under alternative measures. For example, in France, it is typical for the state to control a sizeable portion of large corporations. Therefore, the standard of duty of care is implicit because of the government's financial interest and ownership role in the corporation.<sup>136</sup> On the occurrence of corporate scandals, one source notes, "If that misconduct occurs in a

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<sup>131</sup> Ibid.

<sup>132</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>133</sup> Ibid.

<sup>134</sup> Ibid.

<sup>135</sup> Ibid.

<sup>136</sup> Ibid.

French corporation and it relates to the duty of care, what standard of the duty of care is the attorney to use? The standard honed through U.S. law or that of French law?"<sup>137</sup>

Thus, holding lawyers and other professionals to a duty of care standard as developed by the U.S. is not applicable to many legal systems abroad and, in many cases, the existing foreign legal system may already protect against corporate misconduct.

The bottom line is that Sarbanes-Oxley poses serious legal implications for governments and companies around the world. Extraterritorial application of the Act will likely result in serious clashes of law around the world, making it even more challenging and costly for public corporations and the accounting firms that audit them. The majority of claims thus far are purely hypothetical; however, the day that real conflict of law originates may not be too far ahead. In the event that the hypothetical becomes reality, whose laws are appropriate for foreign entities to follow: their domestic laws or U.S. laws? This question of legitimacy is one that the Board and U.S. government must actively work to resolve before it permanently impairs its international relations.

### *Political Impact*

Business actors, especially multi-national corporations, possess the strength to influence the activities of governments worldwide. The ability to influence political regimes and dominate the political agendas of various nations shows that business units and the state are by no means mutually exclusive concepts.<sup>138</sup> Recent research has attempted to explain the "mediating, regulatory, and sometimes even interventionist role

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<sup>137</sup> Ibid.

<sup>138</sup> Bieling, Hans-Jurgen. "The Other Side of the Coin: Conceptualizing the Relationship between Business and the State in the Age of Globalization." *Business and Politics* Vol. 9, Issue no. 3 (January 11, 2008): April 8, 2008, [http://journals.ohiolink.edu/ejc/article.cgi?issn=14693569&issue=v09i0003&article=1187\\_tosotcsitaog](http://journals.ohiolink.edu/ejc/article.cgi?issn=14693569&issue=v09i0003&article=1187_tosotcsitaog)

of governments and state agencies” with respect to business enterprises.<sup>139</sup> With the onset of globalization, especially in the past thirty years, governments have begun to exhibit a business-oriented approach to policy decisions.<sup>140</sup>

Because the convergence of the world economy and transnational trade are now commonplace, business activity often dominates the government’s agenda. Intense economic competition, both domestic and international, has led many governments to center their agendas around business activity. Business activity leads to economic prosperity and, ultimately, to obtaining the goal nations worldwide seek: power.<sup>141</sup> Hans-Jurgen Bieling, in his article from *Business and Politics*, explains:

Within this fundamentally changed global environment, social and political entities such as the state can only adjust to the overwhelming external pressures of global competition. If they ignore these pressures and try to resist, they must be ready to cope with substantial welfare loss, which in turn may stimulate a reorientation of large parts of the electorate.<sup>142</sup>

This relatively new orientation of governments toward business entities has yet to be extensively researched. Further research on the relationship between business and politics is necessary to fully understand the convergence and development of these two different, but now intertwined, disciplines.<sup>143</sup> However, with the foundation of research Bieling provides, it is possible to extrapolate from his theories the impact Sarbanes-Oxley has had on U.S. politics.

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<sup>139</sup> Ibid.

<sup>140</sup> Ibid.

<sup>141</sup> Ibid.

<sup>142</sup> Ibid.

<sup>143</sup> Ibid.



Globalization has substantially impacted the interrelationship between business and politics in recent years. The creation of Sarbanes-Oxley undoubtedly demonstrates this relationship, revealing the pressure businesses exert on the government and vice versa. In the wake of the Enron and WorldCom collapses in 2002 that left millions of everyday investors financially devastated, American citizens cried out for politicians to take action against those responsible for their financial ruin and also to prevent another scandal of such magnitude. The government's subsequent response to the pressure from constituents reinforces Beiling's theory that the state must act in a manner that is competitive internationally while simultaneously responding to the demands of its domestic citizens.<sup>144</sup> If the state fails to make policy decisions that are favored by constituents and are globally competitive, politicians risk losing their positions and the powers associated with them. For this reason, U.S. politicians created Sarbanes-Oxley, which, with its treatment of foreign companies, sends the message to constituents that the government is concerned about both their interest and staying competitive in the international economy.

Numerous bills were drafted in response to U.S. citizens' concern over the accounting scandals of 2002. Over a time span of less than six months, Sarbanes-Oxley was signed into law on July 30, 2002.<sup>145</sup> In mid-July, WorldCom officially filed for bankruptcy and it became evident that a corporate reform law was needed to crack down on corporate misconduct.<sup>146</sup> One source reports, "The name of Rep. Michael G. Oxley

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<sup>144</sup> Ibid.

<sup>145</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

(R-Ohio) wasn't added to the bill until a last-minute concession by House Republicans after the WorldCom scandal broke and public opinion began to sway in favor of the Democrats as the November 2002 elections were approaching.”<sup>147</sup>

In response to the political pressure on the government, President Bush announced in late July that Congress would not be allowed to begin summer recess, which traditionally begins on August 1<sup>st</sup> each year, until it had created a corporate reform act.<sup>148</sup> As a result, Congressmen Paul Sarbanes and Mike Oxley worked for 72 hours straight in the last week of July to draft the official Act.<sup>149</sup> Congress voted on the bill on July 25, 2002 and the majority of Congress had already left for summer recess when President Bush signed the bill into law on July 30<sup>th</sup>.<sup>150</sup> The storm with which SOX hit Capital Hill was unprecedented and, at the time, few in the accounting profession understood the full implications of the new legislation. One source comments on this era and notes, “The political pressure was unrelenting, with criticism of the SEC coming from every angle as the U.S. public took up the rallying cry for corporate reform.”<sup>151</sup> With that, Congress passed the most sweeping form of securities legislation in U.S. history since the 1933 and 1934 Acts.

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<sup>146</sup> Norris, Floyd. "WorldCom's Collapse Gave Boost to Sarbanes-Oxley: The Timing of the Scandal Helped Build Support for Tougher Rules in the 2002 Bill on Securities Laws." *The New York Times*, July 14, 2005, 2005, sec. Business, [http://www.oregister.com/ocr/sections/business/business\\_nation/article\\_596162.php](http://www.oregister.com/ocr/sections/business/business_nation/article_596162.php).

<sup>147</sup> Fass, Allison. "One Year Later, the Impact of Sarbanes-Oxley." *Forbes.Com* (July 22, 2003, 2003), [http://www.forbes.com/2003/07/22/cz\\_af\\_0722sarbanes.html](http://www.forbes.com/2003/07/22/cz_af_0722sarbanes.html) (accessed May 11, 2008).

<sup>148</sup> Dietrich, Richard. *Personal Recount of Conversation with Congressmen Mike Oxley* April 30, 2008.

<sup>149</sup> Ibid.

<sup>150</sup> Ibid.

<sup>151</sup> "Note: Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." *2004 George Washington University George Washington International Law Review* (2004).

Congressional leaders opposed to this bill were few and far between. The Senate passed SOX unanimously and the House reported only 3 dissenting votes out of 426.<sup>152</sup> Congressman Jeff Flake of Arizona expressed his dissatisfaction with both the Act and the speed with which it was passed.<sup>153</sup> While Flake agrees with the need to reform accounting oversight in the U.S., he believes that SOX is not the ideal answer and that Congress should have taken the time to create a piece of legislation that would not have generated the amount of repercussions that this act did.<sup>154</sup> Flake states, "This hastily created legislation is more of an attempt to politically inoculate ourselves rather than to pass a meaningful bill that cracks down on corporate malfeasance."<sup>155</sup> Congressman Ron Paul of Texas also expresses discontent with the Act and believes that Congress could have created a law that punishes corporate misconduct without positioning the United States for the amount of international backlash it received after the passage of SOX.<sup>156</sup>

Apart from the political repercussions U.S. lawmakers faced upon the creation of Sarbanes-Oxley, continued pressure is being exerted on U.S. politicians over costly provisions of the bill and the limited number of exemptions granted to foreign entities by the PCAOB thus far. One source points out that "in the post-Enron environment, it has become politically risky to provide accounting exemptions to anyone."<sup>157</sup> As a result, it appears that the SEC and the Board fear the political reaction in the U.S. to granting exemptions, especially to foreign companies, over the favorable political reactions abroad

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<sup>152</sup> Becker, Tim and Clarke, Peter. "Is Washington Now the Omnipotent Regulator of the European Financial System?" *Ethical Corporation: Not an Oxymoron*.  
<http://www.ethicalcorp.com/content.asp?ContentID=233> (accessed April 20, 2008).

<sup>153</sup> Ibid.

<sup>154</sup> Ibid.

<sup>155</sup> Ibid.

<sup>156</sup> Ibid.

<sup>157</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

and economic benefits of allowing such exemptions. U.S. political relations with the United Kingdom, Germany, and Japan have been strained from the imposition of Sarbanes-Oxley and these developed countries are outraged that the U.S. will not honor their respective systems of oversight.<sup>158</sup> The argument in the UK is that the government already has a corporate oversight system in place that it has been carefully developing and refining for several years.<sup>159</sup> Public companies in the UK must comply with the Smith Guidance System. Therefore, one source notes, “The comprehensive protections against auditing problems contained in the Smith Guidance make the Sarbanes-Oxley Act requirements unnecessarily duplicative for UK corporations.”<sup>160</sup> The UK government does not believe that, with a respectable oversight system already in operation, the UK also needs the U.S. oversight system imposed on companies as well. In the opinion of UK officials, who is to say that the U.S. system is any better than that of the UK?<sup>161</sup>

On the other hand, American politicians argue that they are dubious about the unwillingness of foreign counterparts to comply with legislation that, in their opinion, protects investors by providing the utmost level of professional care and accountability.<sup>162</sup> After the occurrence of such disgraces as Enron, politicians who were in office at the time of those events are dedicated to preventing future incidents and are unwilling to compromise the provisions of the very act created to safeguard against this. An interesting political theory that sheds light onto this extraterritorial regulation debate is the *Issuer Choice Theory*.

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<sup>158</sup> "Note: Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." 2004 *George Washington University George Washington International Law Review* (2004).

<sup>159</sup> Ibid.

<sup>160</sup> Ibid.

<sup>161</sup> Ibid.

<sup>162</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." 2003 *Columbia Law School Columbia Business Law Review* (2003).

The *Issuer Choice Theory* stipulates that companies worldwide should have the power to decide which regulatory regime they will comply with, similar to the manner that U.S. companies decide the state in which they will incorporate.<sup>163</sup> Under this theory, the regulatory environment a company chooses to abide by is then respected by all regulatory systems throughout the world.<sup>164</sup> In addition, reconciliation or disclosure of differing practices would not be required if a company is publicly-listed on exchanges outside of its regulatory nation in the same way a U.S. company does not have to reconcile its actions to the rule of the states it operates in, but is not the state of its incorporation.<sup>165</sup> This theory of political cooperation is interesting to ponder, but unlikely to receive the support of the United States in the near future. It has been hypothesized that “given Congressional hostility to providing foreign exemptions in Sarbanes-Oxley, it is unlikely that the United States will start making whole scale recognitions of other countries’ securities laws anytime soon. Indeed, the current political climate appears to favor tighter regulation for all issuers, whether domestic or foreign.”<sup>166</sup> Consequently, in place of pursuing an alternative arrangement that could provide tighter accounting oversight and more favorable international relations, the U.S. is politically isolating itself in the hopes of avoiding further protest from the American public regarding its business regulation practices.

#### *Implications for U.S. Foreign Relations*

Foreign relations are the foundation upon which nations throughout the world manage to peacefully coexist with one another. It is inevitable that these relations suffer

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<sup>163</sup> Ibid.

<sup>164</sup> Ibid.

<sup>165</sup> Ibid.

<sup>166</sup> Ibid.

from events that create conflict among nations and, when this occurs, the conflict must be addressed to restore balance to the world's affairs. As one source comments, "From time to time, relations between the United States and other states are strained by actions that others look upon as extraterritorial."<sup>167</sup> Sarbanes-Oxley is no exception to this comment as it has been perceived by foreign nations as a U.S. attempt to super-impose its domestic laws throughout the world. The young legislation has exerted continuous pressure on U.S. foreign relations since its 2002 issuance.

Extraterritoriality disputes in reaction to U.S.-dominant behavior and attempts to control the actions of foreign nations are not new to U.S. foreign relations. Consider past U.S. economic and political boycotts, especially during the Cold War with respect to Russia, Cuba, and China, that at the time represented the core of U.S. foreign relations.<sup>168</sup> The decision to implement the boycotts derived in the U.S. because it was in line with American political self-interest. U.S. threat to penalize its allies that continued to trade with boycotted nations demonstrates the U.S. desire to dictate the actions of other countries to align with its own. If foreign nations did not align with the U.S., those countries found themselves in the unfavorable position of an adversary to the U.S.<sup>169</sup>

Many wonder if Sarbanes-Oxley in coming years will continue to face the resentment, politically, socially, and economically, as past situations involving business and trade aspects of foreign relations in the U.S., have produced. It is still unclear whether the decision to leave or not enter the U.S. capital market at all will be temporary

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<sup>167</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>168</sup> Ibid.

<sup>169</sup> Ibid.

or permanent as a result of SOX.<sup>170</sup> This law is not even six years old and the registration deadline for foreign accounting firms was only two years earlier. As a result, it is still uncertain how this landmark U.S. securities law will mingle in practice with other foreign laws.<sup>171</sup> It is believed by some academics that once the legislation is completely amended and finalized, foreign investors will once again flock to the U.S. capital market.<sup>172</sup> On the other hand, opponents of the Act believe that SOX will negatively impact foreign investment in the U.S. permanently.<sup>173</sup> Regardless of which school of thought ultimately is correct, it is apparent that SOX is causing severe damage to the U.S. image among foreign investors and currently influencing their decision to invest in the U.S.

The nature of Sarbanes-Oxley and its implications for foreign entities make this Act not only a securities reform law, but also a significant component of U.S. foreign relations. The implications for foreign relations were either not considered during the drafting of SOX or else ignored by lawmakers in the process. Lawrence Cunningham, a professor of law at Boston College, states, "Political blindness to the international relations viewpoint was evident from the US failure to consult regulatory counterparts abroad and from the heated political rhetoric accompanying SOX."<sup>174</sup> The lack of regard for international practices and the reaction to imposing the requirements of the Act outside U.S. borders has brought Sarbanes-Oxley to the forefront of U.S. foreign

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<sup>170</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

<sup>171</sup> Ibid.

<sup>172</sup> Ibid.

<sup>173</sup> Ibid.

<sup>174</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." *Boston College Law*, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

relations. This undoubtedly could have been avoided and saved U.S. relations from the damage it incurred had the U.S. taken foreign concerns into account prior to super-imposing legislation extraterritorially.

Many claims have risen that the U.S. is overstepping its bounds with Sarbanes-Oxley and is blatantly violating the basic norms of respecting international sovereignty.<sup>175</sup> In today's globalized world, markets are becoming increasingly international and are inexorably intertwined with one another as a result.<sup>176</sup> Communication between all countries is necessary to allow for this type of global marketplace in order to understand the laws and cultural norms each nation brings to the table for trade. The United States' decision to essentially disregard communication with other nations during the creation of Sarbanes-Oxley and the subsequent passage of the law has resulted in concern among foreign nations over American imperialist-like activities.<sup>177</sup>

Graham Ward, a board member of the International Federation of Accountants, is opposed to Sarbanes-Oxley and points to the U.S. struggle for independence in the 18<sup>th</sup> century to demonstrate why he believes SOX is a hypocritical imposition of regulation on the part of the U.S.<sup>178</sup> He quotes American values embedded in the U.S. Declaration of Independence, stressing that a nation's rulers "derive their just powers from the consent

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<sup>175</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>176</sup> Text: Rules Changes Will Bolster Confidence, SEC Commissioner Says; Changes Treat Foreign and Domestic Companies Equally, Campos Adds. *State Department*, June 12, 2003.

<sup>177</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>178</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.



of the governed.”<sup>179</sup> Ward argues that Sarbanes-Oxley represents the very opposite of this sacred American value. By imposing the regulations of this Act on entities outside of the control of the U.S. government and also without their consent, the U.S. is withholding basic rights that centuries ago it fought so hard to obtain.<sup>180</sup> SOX leads to feelings of repression among foreign nations, whose affected companies now must comply with a stringent law created in another nation and without foreign consultation.

The tenets of SOX in theory provide the SEC with jurisdiction outside the U.S., calling into question the comity of the international community and straining foreign relations as a result.<sup>181</sup> The U.S. government now must answer to the international community and its demand for granting exemptions to foreign entities.<sup>182</sup> It is interesting to note that Congress and President Bush are celebrated by U.S. constituents for the creation of the Act and protecting their interests in the wake of such scandals as Enron and WorldCom. However, when U.S. foreign relations exploded from the international reaction to SOX, the very politicians who endorsed the legislation turned to the SEC to deal with the conflict, probably out of fear of losing voter support. The SEC is now left to address the political pressure coming in full force from two different directions: domestic supporters of SOX and international objectors to it. While the SEC is faced with the daunting task of cleaning up this political mess, Congress is patting itself on the back for creating a law it believes will protect everyday U.S. investors from future accounting scandals. It is evident that “in the future, when Congress regulates US capital

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<sup>179</sup> Ibid.

<sup>180</sup> Ibid.

<sup>181</sup> Bather, Andrea and Priscilla Burnaby. "The Public Company Accounting Oversight Board: National and International Implications." *Managerial Auditing Journal* 21, no. 6 (2006): 657.

<sup>182</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

markets and SEC registrants, it should not punt to the SEC to hedge the resulting international relations fall-out but address that thicket up front.”<sup>183</sup>

Congress’s disregard for Sarbanes-Oxley’s impact abroad during the U.S.’s mad rush to put an end to the disastrous corporate scandals is apparent. However, consultation with other nations and their government, business and legal professionals might have prevented the U.S. from the foreign relations debacle it is currently in as a result of this statute.<sup>184</sup> The fact that corporate governance and oversight is by no means a one size fits all model, the institutional differences that invariably exist throughout the world imply that the U.S. model simply does not fit the needs of many nations.<sup>185</sup> This breeds animosity toward the U.S. and one source condemns Congress “for neglecting to consider the diplomatic consequences of such far-reaching and unilateral actions such as Sarbanes-Oxley.”<sup>186</sup>

The main takeaway from SOX and its negative reaction abroad is that Congress should have first only applied the Act to domestic companies.<sup>187</sup> This would have satisfied the U.S. citizenry’s cry for government action after the corporate misconduct and also provided the opportunity for U.S.-foreign dialogue. The dialogue would have addressed treatment of non-U.S. firms in the hopes of developing a solution that would protect investors, ease foreign concerns, and save the U.S. from irreparable damage to its

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<sup>183</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." Boston College Law, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>184</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>185</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

<sup>186</sup> Ibid.

<sup>187</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." Boston College Law, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

foreign relations.<sup>188</sup> Instead, the U.S. plowed ahead with Sarbanes-Oxley and created an obstacle to open trade in today's global marketplace.<sup>189</sup> Cunningham describes the fast-moving actions of the U.S. and their subsequent consequences by saying, "It was a case of domestic political pressures blinding lawmakers to important matters of international relations. It was a wasted opportunity to exhibit comity in the exercise of US power on a matter that would have cost the US little."<sup>190</sup> His comments reiterate a fundamental principal of foreign relations theory: diplomacy as a preventative measure often serves in the best interest of all and usually results in conflict avoidance. Had the U.S. practiced proactive diplomacy prior to the imposition of the Act abroad, it is likely that it could have avoided the backlash that resulted in response to SOX.

Sarbanes-Oxley's divergence from the traditional practice in foreign relations of avoiding international economic conflict, or to at least initially engage in dialogue as a preventive measure, severely impacts foreign perception of the U.S. and the attractiveness of the U.S. market.<sup>191</sup> Foreign companies in the past have not taken significant issue with complying with U.S. securities laws because the regulation has traditionally adapted provisions in order to meet international needs.<sup>192</sup> After SOX, non-U.S. companies are confused by Congress's sudden shift in accommodation and angered

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<sup>188</sup> Ibid.

<sup>189</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

<sup>190</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." *Boston College Law*, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>191</sup> "Note: Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." *2004 George Washington University George Washington International Law Review* (2004).

<sup>192</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." *2003 Columbia Law School Columbia Business Law Review* (2003).

at the impact the law has on their business practices.<sup>193</sup> Consequently, the U.S. is trying, after the fact, to repair the damage SOX has generated abroad in lieu of addressing the Act's impact and U.S. response to it beforehand.

The U.S., in keeping with its traditional receptiveness to the international implications of its securities laws, should have engaged in open diplomacy with foreign regulators and affected companies prior to imposing the Act abroad. Cunningham purports, "If this were done with SOX, the world would have arrived at the same place, without undesirable political agitation, anxiety, and backlash risks. This underscores the international relations aspect of US corporate regulation amid globalization."<sup>194</sup> The SEC is now engaged in dialogue with its foreign counterparts and attempting to satisfy the international community's demands while trying to balance domestic political interests at the same time.<sup>195</sup> SEC representatives stress that the Commission does not want the international companies to be placed in an unfeasible situation where they are facing conflicts of law, but also emphasizes that its number one responsibility is protecting the U.S. investment community.<sup>196</sup>

As a result, "the SEC has indicated that in certain areas it will take into account foreign laws and practices in applying the provisions to foreign accounting firms."<sup>197</sup> The international community is paying close attention to the SEC and the fulfillment of its vows to address foreign interests. In fact, former SEC Chairman Harvey Pitt was

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<sup>193</sup> Ibid.

<sup>194</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." Boston College Law, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>195</sup> Text: Rules Changes Will Bolster Confidence, SEC Commissioner Says; Changes Treat Foreign and Domestic Companies Equally, Campos Adds. *State Department*, June 12, 2003.

<sup>196</sup> Ibid.

<sup>197</sup> Better Governance and Reporting Under Sarbanes - Oxley : Are we there Yet? *Mondaq Business Briefing*, November 23, 2004.

going to skip an EU conference on SOX, citing political tensions in the U.S. as his excuse for not attending.<sup>198</sup> However, EU representatives stressed the importance of his presence to show the SEC's commitment to its foreign counterparts and working together to resolve differences resulting from SOX.<sup>199</sup> Ultimately, Pitt wisely attended the conference and avoided creating further damage to U.S. foreign relations.

Other critics chastise Sarbanes-Oxley as being too "US-centric," claiming that the burden of this legislation abroad naturally conflicts with existing foreign institutions. In addition, the international community perceives the U.S. as having an ethnocentric view with respect to its accounting system.<sup>200</sup> Instead, the U.S. needs to recognize the American cultural norms embedded in the Act and that foreign cultures do not always reflect these same norms. In recognizing this seemingly obvious fact, the U.S. should accommodate to the differences rather than giving the impression that foreign companies must conform to the American way if they wish to continue to participate in the U.S. market.<sup>201</sup> International entities' impression of Sarbanes-Oxley is essentially that the U.S. believes its business culture is superior and all others are innately inferior and deficient.<sup>202</sup> It conveys the message to foreigners that they must adopt the U.S. business structure necessary to comply with SOX or else look to participate in capital markets outside of the U.S., irrespective of the cultural roots of their domestic business

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<sup>198</sup> Sarbanes - Oxley Debate: Will Pitt Offer Compromise for Non-US Firms? *The Accountant*, October 21, 2002. 3.

<sup>199</sup> Ibid.

<sup>200</sup> "SURVEY: SARBANES - OXLEY , FOREIGN ISSUERS AND UNITED STATES SECURITIES REGULATION." 2003 *Columbia Law School Columbia Business Law Review* (2003).

<sup>201</sup> "Note:Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." 2004 *George Washington University George Washington International Law Review* (2004).

<sup>202</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." 2004 *Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

environment.<sup>203</sup> As one source notes, “Ultimately, in order to adopt SOX’s corporate governance model, foreign corporations are forced to either compromise or abandon their own cultural values.”<sup>204</sup> The intrinsically individualistic nature of SOX is appropriate for the U.S. culture, however this could not be farther from the truth for cultures that promote collectivism.<sup>205</sup>

It is ironic to Europeans that the U.S. suffered from corporate scandals despite its belief in the superiority of the U.S. accounting system and standards.<sup>206</sup> Furthermore, many perceive the United States’ attempt to correct the business environment in which the scandals were able to occur and impose the new regulations abroad without international consideration as insulting.<sup>207</sup> Although other nations are not entirely free from similar corporate scandals, perhaps the most well known international scandal is Italy’s Parmalat fiasco, it is commonly believed that these scandals are “very much an American phenomenon.”<sup>208</sup> Consequently, internationally there is a tendency for professionals to reject the integrity of the U.S. regulation system or, at the very least, an inclination to question the new Act, which dictates that foreign public companies and their auditors adopt its regulations.

Prior to Sarbanes-Oxley, the international business community was striving to converge accounting practices worldwide. Unfortunately, the introduction of SOX

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<sup>203</sup> Ibid.

<sup>204</sup> Ibid.

<sup>205</sup> Ibid.

<sup>206</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>207</sup> Ibid.

<sup>208</sup> "NOTE: International Law and the Ramifications of the Sarbanes-Oxley Act of 2002." *2004 Boston College International & Comparative Law Review Boston College International and Comparative Law Review* (Spring, 2004).

severely impairs U.S. foreign relations with other nations to achieve this goal.<sup>209</sup> Those nations who are committed to finding a common solution to the international problem of accounting oversight that will suit the needs of the globalized economy were offended by the U.S.'s decision to rashly pass this law without foreign consultation. Dialogue is a key component of international relations and is what countries worldwide have been utilizing to develop a system of accounting oversight suitable for many nations of varying cultural and institutional backgrounds.<sup>210</sup> SOX has damaged the perception abroad that the U.S. is willing and supportive of working together to develop an international system.

Opponents of the Act argue, "Regulators in the United States should abandon efforts to extraterritorially impose [its] corporate governance legislation and instead work towards a global regulatory regime."<sup>211</sup> On the other hand, it is possible that Congress's decision to pass the Act without discussion with its foreign counterparts could bar the U.S. from future participation in the development of a worldwide oversight system if its foreign relations have been too damaged. Had the United States been an active proponent of foreign dialogue initially, it would not find itself in a position where the rest of the world is opposed to the U.S. system and could potentially devise a system of its own without consulting the U.S.

It is believed that the U.S. could face retribution in the form of international legislation similar in scope to Sarbanes-Oxley. One source states, "Foreign regulatory bodies have threatened to retaliate against U.S. firms by imposing requirements similar to

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<sup>209</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." *Boston College Law*, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>210</sup> Ibid.

<sup>211</sup> "Note: Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality." *2004 George Washington University George Washington International Law Review* (2004).

those of the Sarbanes-Oxley Act.”<sup>212</sup> Imagine the endless number of oversight systems that would emerge if every other nation in the world chose to develop their own regulation laws without consulting its international counterparts in the same manner the U.S. developed SOX. If this were to occur, in theory, a multinational company would have to comply with its home laws as well as the laws of over 190 other countries if the company was active in each nation in the world. This clearly demonstrates the importance of foreign relations worldwide and the need for every nation to be diplomatic out of consideration of the impact its laws and actions have on the international community.

The Congressional hearings for the Act did not provide an opportunity for foreign regulators to voice their concerns about the proposed legislation before it was extraterritorially imposed on their domestic companies who are listed in the U.S. or participate in the audits of listed companies.<sup>213</sup> Although it is not required under U.S. law to provide this opportunity, the United States would have saved the blow to its foreign relations by granting this courtesy to foreign nations.<sup>214</sup> One source comments, “On the road to promoting investor protection and stable markets, [...] there is not just one right path. Countries have different regulatory approaches and different legal, political and economic systems that must be respected and taken into account.”<sup>215</sup> Congress’s decision to ignore these inherent differences and create SOX generated a negative reaction abroad

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<sup>212</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>213</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." *Boston College Law*, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>214</sup> Ibid.

<sup>215</sup> Text: Rules Changes Will Bolster Confidence, SEC Commissioner Says; Changes Treat Foreign and Domestic Companies Equally, Campos Adds. *State Department*, June 12, 2003.



and could impact PCAOB and SEC attempts to enforce the new law in the future.

Without foreign support, it will be challenging for the U.S. to gain the support it needs to ensure foreign compliance with SOX, thus defeating the purpose of extending the Act's reach to include international entities.<sup>216</sup> Undoubtedly, the biggest error of Congress was not addressing existing foreign oversight systems in the process of generating Sarbanes-Oxley.

Congress's lack of regard for the international impact of SOX strains foreign relations with some of the United States' long-standing allies and trade partners.<sup>217</sup> As Cunningham wisely advises, "The world's unipower owes its friends respect, particularly friends whose own history is marked by global preeminence."<sup>218</sup> Although the future of Sarbanes-Oxley is not certain, it is clear that the United States' actions, or lack thereof, toward foreign nations have not been well received. If the U.S. continues down this ethnocentric path of regulation that is severely damaging its foreign relations, it will risk isolating itself from the international community. Moreover, the powerful nation could lose its power to those nations who reject SOX and successfully draw public companies away from the U.S. capital market toward other markets that operate under a more flexible regulatory environment. The U.S. should focus on repairing tensions with its allies as a result of this Act and in the future strive to avoid creating an extraterritorial nightmare for its foreign relations.

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<sup>216</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." Boston College Law, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>217</sup> Ibid.

<sup>218</sup> Ibid.

## PART IV

### *Demand for Alternative Solutions*

As the arguments in the preceding sections of the paper illustrate, Congress's creation of the Sarbanes-Oxley Act, while intended to protect investors' interests, did not succeed in developing an oversight solution that is accepted throughout the world. The economic, legal and political problems generated by SOX has impacted the standing of the U.S. worldwide and jeopardized its foreign relations with many nations, including its closest allies. As a result, there has been considerable demand for the U.S. to amend some of its provisions with respect to those involving foreign entities. Because of domestic political provisions, the U.S. has been hesitant to grant exemptions to foreign firms from the Act. However, there are two alternative paths the U.S. can proceed down to rectify the international conflict created by the Act. The first alternative involves working with foreign nations to develop an international body of accounting oversight. The second alternative entails U.S. recognition of and reliance on foreign oversight systems to carry out the mission of the PCAOB.

### *Alternative One: Development of an International Oversight Body*

Adherence to multiple regulatory bodies is a costly and confusing process for entities worldwide. Presently, foreign companies and accounting firms have been struggling to comply with their home country system, which may be in the process of undergoing significant change, as well as the complex U.S. regulatory environment developed under Sarbanes-Oxley. It is believed that it would benefit business entities worldwide if regulatory systems from different nations were able to work together to

develop an international regulatory body charged with global accounting oversight.<sup>219</sup>

Professionals would benefit from the development of a single set of rules, free from convoluted language, and applicable to many business cultures as opposed to just one.

Graham Ward believes that creating a single, international system of regulation would provide the opportunity for economic growth throughout the world in place of the economic decline impacting nations similar to the way SOX affected the U.S. economy.<sup>220</sup> One common international system would likely reduce the risk of fraud and corporate misconduct because everyone would be held to the same, accepted set of standards.<sup>221</sup> One source states, "Just as the Organisation for Economic Co-operation and Development has served as a useful forum for anti-trust and tax concern common to all governments, the International Organization of Securities Commissions would be the place to discuss common interests in securities regulation and corporate governance."<sup>222</sup> It has been proposed that regulators around the world work to create an international auditing standard setting organization, utilizing the strengths of oversight systems currently in place and eliminating the weaknesses that exist in those systems.<sup>223</sup> Unfortunately, if the unwillingness of the SEC to compromise the U.S. GAAP system of accounting to conform with the International Accounting Standards Board's rules is any indication, convergence to a global oversight system appears unlikely to succeed anytime

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<sup>219</sup> Newman, Bernard H. and Mary Ellen Oliverio. "Perceived Flaws in Sarbanes-Oxley Implementation." *The CPA Journal* 76, no. 9 (Sep, 2006): 6.

<sup>220</sup> "Notes from AICPA Spring Council: Agenda Includes International Standards, Cost of SOX Compliance." *Inside Public Accounting* 19, no. 6 (Jun, 2005): 5.

<sup>221</sup> Ibid.

<sup>222</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." *2003 the American Society of International Law American Journal of International Law* (April, 2003).

<sup>223</sup> Giles, Jill P., Elizabeth K. Venuti, and Richard C. Jones. "The PCAOB and Convergence of the Global Auditing and Accounting Profession." *The CPA Journal* 74, no. 9 (Sep, 2004): 36.

soon.<sup>224</sup> The second proposed solution provides an alternative option to global convergence and may prove successful at least in the near future.

*Alternative Two: Mutual Recognition*

A second alternative to Sarbanes-Oxley as originally proposed concerns the U.S. granting mutual recognition to those countries with a suitable accounting oversight system in place. Because there are certain inherent differences among nations throughout the world, mutual recognition would recognize the legitimacy of other oversight systems while also respecting each nation's right to sovereignty that is violated under the original tenets of SOX.<sup>225</sup> Foreign entities believe that the U.S. should devise a system that would evaluate the credibility of foreign oversight systems and determine whether to accept these systems as quasi-equivalent to the U.S. system.<sup>226</sup> This would remove the extraterritorial component of the Act for the most part while still achieving the primary objective of SOX: protecting investors.

The extent to which the U.S. would rely on foreign oversight systems is still highly contested. Foreign nations urge the U.S. to consider full reliance on the system if it is deemed acceptable by the PCAOB. On the other hand, the PCAOB recognizes that mutual recognition would allow greater respect of institutional and legal differences inherent to oversight systems throughout the world, but does not support the idea of full reliance.<sup>227</sup> Partial reliance on foreign systems is under consideration by the Board and the SEC defends its actions, saying that "the SEC, as well as any national regulator, has

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<sup>224</sup> "EDITORIAL COMMENT: Extraterritoriality and the Corporate Governance Law." 2003 *the American Society of International Law American Journal of International Law* (April, 2003).

<sup>225</sup> Eu Warns on Sarbanes - Oxley Act. *Financial News (Daily)*, September 6, 2002.

<sup>226</sup> The Impact of Sarbanes-Oxley Act on Non-U.S. Accounting Firms. *Journal of International Business Research*, January, 2005. 1.

<sup>227</sup> Ibid.

the right to determine the terms and conditions under which financial service providers access investors in its jurisdiction.”<sup>228</sup> Cunningham discusses a classification system for countries appropriate for a mutual recognition system, regardless of the degree of recognition the U.S. grants. He believes that nations will be classified as one of two types: Favored Nations or World Class Countries.<sup>229</sup> The U.S. will perceive favored nations as having a satisfactory regulatory framework and World Class Countries will be those nations who lack an oversight system, but choose to implement and regulate U.S. standards.<sup>230</sup>

If the U.S. devises a system to evaluate foreign oversight, it could greatly reduce negative perception of SOX, diminish inefficient regulation and enforcement, and simultaneously improve its foreign relations. On the concept of mutual recognition, Cunningham states, “The key international relations benefit of such a measure is the result creates a measure of voluntary compliance compared to that generated by a unilateral fiat such as SOX.”<sup>231</sup> In providing foreign nations the opportunity to either demonstrate the integrity of its domestic system or allow nations who lack a regulatory system to choose to implement the standards, the U.S. is ultimately acting in a manner that is more receptive to international needs. The international community accepts this because foreign nations now play a greater role in their fate as opposed to its actions being dictated by the U.S. watchdog, as it appeared to be in the past.

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<sup>228</sup> Text: Rules Changes Will Bolster Confidence, SEC Commissioner Says; Changes Treat Foreign and Domestic Companies Equally, Campos Adds. *State Department*, June 12, 2003.

<sup>229</sup> Cunningham, Lawrence C. "From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX." *Boston College Law*, 2003, [http://papers.ssrn.com/sol3/cf\\_dev/AbsByAuth\\_LAB.cfm?per\\_id=185113](http://papers.ssrn.com/sol3/cf_dev/AbsByAuth_LAB.cfm?per_id=185113) (accessed April 27, 2008).

<sup>230</sup> Ibid.

<sup>231</sup> Ibid.

*The Development of Sarbanes-Oxley and the PCAOB*

The PCAOB has made considerable progress in the years that have passed since Sarbanes-Oxley was first issued. The Board has recognized the impact of the Act abroad and the subsequent implications for U.S. foreign relations. It has made significant advancements in its consultation with foreign counterparts and is proactive in promoting dialogue both with international regulators and professional auditors. This dialogue has allowed the PCAOB to obtain a greater understanding of the perceptions that exist around the world about the provisions of SOX and rules that have been created by the Board. Additionally, complaints about the costliness of the Act have been declining because costs of compliance have been decreasing for public companies as they become more adept at satisfying the requirements of the Act.<sup>232</sup> It is estimated that between 2006 and 2007 compliance costs fell by 5.4% for companies, a statistic that has been well-received by those companies affected by SOX. The remainder of this section discusses the specific steps recently taken by the PCAOB to address foreign concerns and promote dialogue as well as plans the Board has regarding its future strategy to achieve investor protection.

With registered public accounting firms representing over 85 countries throughout the world, the PCAOB has been working on the development of specific rules designed to specifically address treatment of foreign firms.<sup>233</sup> The idea behind this series of rules is that the Board would rely under certain circumstances on inspections conducted by

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<sup>232</sup> Auger, James. "Costs of Complying with Sarbanes-Oxley U.S. Corporate Regulations Coming Down." *Global Insight*, May 1, 2008.

<sup>233</sup> Goelzer, Daniel L. "Opening Statement of Daniel L. Goelzer, Board Member at the Open Meeting to Consider Proposing Release of Full Reliance Policy Statement." Washington D.C., PCAOB, December 5, 2007, 2007, [www.pcaobus.org](http://www.pcaobus.org) (accessed May 2, 2008).

foreign regulators.<sup>234</sup> A country's eligibility for this will depend on the characteristics of its domestic oversight system, especially with respect to the relationship between its regulators and auditors.<sup>235</sup> Daniel L. Goelzer, a member of the Board, comments on the proposed rule concerning reliance on foreign regulation, stating, "This sliding scale approach permits the Board to be faithful to [its] Congressional mandate but at the same time to utilize the work of non-U.S. regulatory systems when that is consistent with our mandate."<sup>236</sup> Essentially, the PCAOB has come to realize that joint cooperation with foreign regulators could potentially provide greater investor protection because the involvement of more regulators results in access to greater resources and increases the total number of inspections completed.<sup>237</sup> Meanwhile, foreign tensions are greatly diffused because foreign nations no longer feel completely violated by U.S. extraterritoriality.

In response to problems arising from the imposition of the Act abroad, the Board has established a system that evaluates whether the PCAOB is allowed to rely on foreign regulators to carry out the Board's duties and to what extent.<sup>238</sup> The Board has come to realize that cooperation with foreign regulators will "minimize administrative burdens and legal conflicts that firms face and [...] conserve Board resources, without undermining or ignoring the Board's statutory mandates."<sup>239</sup> As a result, the PCAOB has worked hard to develop and refine five new rules addressing its interpretation of mutual

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<sup>234</sup> Ibid.

<sup>235</sup> Ibid.

<sup>236</sup> Ibid.

<sup>237</sup> Ibid.

<sup>238</sup> Public Company Accounting Oversight Board. *Final Rules Relating to the Oversight of Non-US Public Accounting Firms* PCAOB Rulemaking Docket Matter No. 013, 2004, [www.pcaobus.org](http://www.pcaobus.org) (accessed May 2, 2008).

<sup>239</sup> Ibid.

recognition. Upon the initial completion of these rules, the Board released them to auditing professionals and regulators for feedback on the implementation of the rules in practice.<sup>240</sup> After receiving this valuable feedback, the PCAOB further revised the five rules to the form they exist in today.

The first of the five rules is Rule 4011, titled “Statement by Foreign Registered Public Accounting Firms.” This rule describes a one-time statement created by those foreign firms who would like the Board to rely on a home country inspection.<sup>241</sup> This statement must be certified by a company official and the PCAOB will work directly with the regulators of the firm’s home country to gain an understanding of its oversight system.<sup>242</sup> The second rule, Rule 4012, “Inspections of Foreign Registered Public Accounting Firms,” discusses the criteria relied upon by the Board to evaluate foreign regulatory systems.<sup>243</sup> The extent to which the Board will rely on foreign inspections depends on the evaluation of the following five factors: (1) System integrity; (2) Independence of regulators from auditors; (3) Source of funding; (4) Degree of system transparency; and (5) Past ability of the system to adequately perform.<sup>244</sup> Rule 4012 also provides a clause stating the importance of Board dialogue with its foreign counterparts in order to establish a cooperative work arrangement.<sup>245</sup>

The next rule in the series, Rule 5113, titled “Reliance on the Investigations of Non-U.S. Authorities,” concerns the Board’s reliance upon foreign disciplinary actions not originally instigated by the United States. This particular rule is still causing

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<sup>240</sup> Ibid.

<sup>241</sup> Ibid.

<sup>242</sup> Ibid.

<sup>243</sup> Ibid.

<sup>244</sup> Ibid.

<sup>245</sup> Ibid.



international controversy because of double jeopardy concerns, implying that foreign entities could potentially face repercussions from multiple regulators in response to the same action.<sup>246</sup> Despite feedback expressing dissatisfaction with Rule 5113, the Board will not relent, stating that foreign regulators' objectives and the Board's are not one and the same.<sup>247</sup> Therefore, if one foreign company's actions violate its home country law and U.S. law, it is still subject to discipline under both jurisdictions, a consequence firms should be aware of from operating across multiple jurisdictions.<sup>248</sup>

The final two rules, Rules 6001 and 6002, concern PCAOB policy of providing assistance to foreign regulators' activities.<sup>249</sup> Titled "Assisting non-U.S. Authorities in Inspections" and "Assisting non-U.S. Authorities in Investigations," respectively, these rules address the right of the Board to help other nations enforce their own versions of SOX-like legislation with respect to U.S. public accounting firms.<sup>250</sup> Although these actions are not defined specifically within the body of Sarbanes-Oxley, Rules 6001 and 6002 are legitimized by the catch-all clause included in the Act.<sup>251</sup> This clause authorizes the SEC the power to legally grant the PCAOB any powers it deems as necessary to carrying out the Board's mission.<sup>252</sup> Both the SEC and the PCAOB believe that Rules 6001 and 6002 are consistent with the Board's mission.

Although the introduction of these five rules represents a significant attempt on the part of the PCAOB to engage in cooperative dialogue with its foreign counterparts,

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<sup>246</sup> Ibid.

<sup>247</sup> Ibid.

<sup>248</sup> Ibid.

<sup>249</sup> Ibid.

<sup>250</sup> Ibid.

<sup>251</sup> Ibid.

<sup>252</sup> Ibid.

the Board is still not completely free from criticism. The PCAOB is still opposed to a system of mutual recognition where it would completely rely on its foreign counterparts to carry out its mission and objectives.<sup>253</sup> The Board claims that this “approach would [not] be in the interests of U.S. investors or the public.”<sup>254</sup> The PCAOB believes that avoiding complete deference to foreign authorities allows it to maintain the right to step in at any time with the treatment of foreign registered firms if such a situation is warranted.<sup>255</sup>

Additionally, in response to the evaluation of the five factors to determine the Board’s reliance on foreign regulators, the PCAOB has expressed its intention to evaluate non-U.S. systems as a whole, rather than as a sum of its individual parts.<sup>256</sup> One source criticizes the Board’s strict requirements to permit foreign oversight and deducts, “In other words, the PCAOB would rely on local oversight systems that were in essence structured the same as its own.”<sup>257</sup> The Board believes it will achieve more objectivity toward its assessment of systems not identical to the U.S. oversight structure.<sup>258</sup>

Finally, although the PCAOB now encourages open discussion with representatives of foreign oversight systems during its evaluation of those systems, it has decided that once the Board has produced its final evaluation of the system, there will not be an appeal process for the international representatives to overturn the decision.<sup>259</sup> The

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<sup>253</sup> Ibid.

<sup>254</sup> Ibid.

<sup>255</sup> Ibid.

<sup>256</sup> Ibid.

<sup>257</sup> Giles, Jill P., Elizabeth K. Venuti, and Richard C. Jones. "The PCAOB and Convergence of the Global Auditing and Accounting Profession." *The CPA Journal* 74, no. 9 (Sep, 2004): 36

<sup>258</sup> Public Company Accounting Oversight Board. *Final Rules Relating to the Oversight of Non-US Public Accounting Firms* PCAOB Rulemaking Docket Matter No. 013, 2004, [www.pcaobus.org](http://www.pcaobus.org) (accessed May 2, 2008).

<sup>259</sup> Ibid.

PCAOB will only change its assessment of a particular oversight system if future changes were made to a country's system thus strengthening the integrity of it. This has not been well-received internationally because, in the event a country feels that the Board's assessment is not reflective of its system, foreign regulators will not have the opportunity to argue against the evaluation.

The PCAOB recently released its Strategic Plan for 2008-2013 and a considerable portion of its plan has been dedicated to continuing its cooperative efforts with international regulators and companies. Per the Board's plan, one of its published goals is as follows: "Work effectively with international audit regulators to facilitate inspections of non-U.S. registered public accounting firms and to strengthen global oversight of U.S. public companies."<sup>260</sup> In addition, the PCAOB hopes to develop a more definitive policy describing its relationship and cooperation framework with its foreign regulatory counterparts.<sup>261</sup> This represents a huge step for the Board to incorporate this goal into its agenda, although it fails to go describe in detail how it hopes to achieve this objective. The PCAOB also plans to assume a leadership role within the global regulatory framework, hoping to both teach foreign regulators and learn from them, as long as the lessons are in line with the U.S. regulatory vision.<sup>262</sup> This represents quite the contrast to the Board's original stance toward the international community upon its creation.

In addition, the plan provides measures to evaluate PCAOB progress toward achieving its stated goals. Currently, the Board has either performed the dictated number

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<sup>260</sup> Public Company Accounting Oversight Board. PCAOB 2008-2013 Strategic Plan 2008, [www.pcaobus.org](http://www.pcaobus.org) (accessed May 2, 2008).

<sup>261</sup> Ibid.

<sup>262</sup> Ibid.

of foreign accounting firm inspections directly, after obtaining foreign government permission, or in conjunction with foreign regulatory institutions.<sup>263</sup> The PCAOB projects that it will inspect approximately 72 and 101 foreign firms in 2008 and 2009, respectively. Furthermore, the Board has made considerable progress in recognizing the need for diplomatic relations with foreign nations in order to obtain their cooperation with PCAOB inspections or enforcement actions outside U.S. borders.<sup>264</sup> In seeking to effectively work in conjunction with foreign regulators, the U.S. is not perceived as being as intrusive as it was when SOX first emerged. Also, the PCAOB has created an international forum, known as the International Auditor Regulatory Institute, to not only address the idea of a global oversight system, but also to enhance international participants' understanding of the Board's methodology and rationale behind its standards.

By helping international regulators understand the Board's activities, the PCAOB hopes to change the international perspective of SOX as an unwarranted imposition into a warranted measure intended to protect investors. Although these steps have been significant for the PCAOB, in reality the Board is only acting in a manner consistent with international requests that emerged at the onset of Sarbanes-Oxley. It is apparent, however, that the PCAOB has recognized the impact the Act has had on foreign relations and is doing its best to amend the strains that resulted from SOX.

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<sup>263</sup> Ibid.

<sup>264</sup> Ibid.

## CONCLUSION

This study has interpreted the provisions of the Sarbanes-Oxley Act and the difficulties entities face incorporating the Act's requirements into their business practices. Part I focused on domestic and foreign registration with the PCAOB. In Part II, a thorough examination of the history of U.S. securities legislation provided the foundation upon which it was possible to compare and contrast SOX with existing securities laws. PART III of the study explored the economic, legal and political impact of the Act in order to demonstrate the implications of it for U.S. foreign relations. The final section explored alternative solutions to Sarbanes-Oxley and the development of SOX and the PCAOB to date.

Although the PCAOB has taken significant steps to rectify the impact of SOX abroad and its blow to U.S. foreign relations, the U.S. will need to continue to encourage foreign dialogue and promptly respond to international concerns over SOX. If the U.S. does not respond to international concerns over SOX, foreign company membership on the U.S. market could continue to decline and the U.S. will isolate itself, suffering politically, economically, and socially. While the future of the Sarbanes-Oxley Act is not certain, it is certain that global accounting oversight will continue to play a role in future U.S. foreign relations and the U.S. will need to react to accounting oversight with greater care than it did its first time around.

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